AUDITING
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UNIT – 1
AUDITING

Audit

The term audit is derived from a Latin word “audire” which means to hear authenticity of accounts is assured with the help of the independent review.

Audit is performed to ascertain the validity and reliability of information. Examination of books and accounts with supporting vouchers and documents to detect and prevent error, fraud is the primary function of auditing.

Auditor has to check the effectiveness of internal control systems for determining the extent of checking out the audit.

But the word audit has an extensive usage, and it now means a thorough scrutiny of the books of accounts and its ultimate aim is to verify the financial position disclosed by the balance sheet and profit and loss accounts of a company.

In short, an audit implies an investigation and a report. The process of checking and vouching continues until the study is completed and the auditor enables himself to report under the terms of his appointment.

Definition of Audit

“An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which the purport to relate.” – **Lawrence R. Dickey**

“Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement.” **– Taylor and Perry**

“An audit denotes the examination of balance sheet and profit and loss accounts prepared by others together with the books of accounts and vouchers relating thereto such in such a manner that the auditor may be able to satisfy himself and honestly report that in his opinion such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of a particular concern according to the information and explanations given to him and as shown by the books.” **- F.R.M De Paula**

“Audit such an examination of the books of accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up so as to give a fair and true view of the state of affairs of the business and the whether the profit and loss of accounts gives a true and fair view of profit and loss for the financial period according to the best of his information and explanations given to him and as shown by the books and if not in what respect he is not satisfied.” **– Spicer & Pegler**

Basic Principles Governing an Audit

Auditing is a systematic and scientific procedure of inspection of the financial statements of an organization. And like any scientific procedures, the audit also has certain principles and rules that govern it. These principles are the Standards of Auditing or the Auditing and Assurance Standards (AAS). Let us now take a look at some basic principles governing an Audit:

1. Integrity, Independence and Objectivity

The auditor has to be honest while auditing, he cannot be favoring the organization. He must remain objective throughout the whole process, his integrity must not allow any malpractice.

Another important principle is independence. So the auditor cannot have any interest in the organization he is auditing, which allows him to be independent and impartial at all times.

2. Confidentiality

The auditor has access to a lot of sensitive financial information of the organization. It is important that he respect the confidential nature of such information and documents.

He cannot disclose any sensitive information to any third party unless it is a requirement by law. And he must also be very careful with documents, certificates etc. that the organization entrusts to him.

3. Skill & Competence

The auditor must be experienced and trained in the procedures of auditing, i.e. must be qualified as an auditor. And as a professional, he must be up to date on recent changes, announcements, rules etc.

If necessary he can undergo training and workshops to stay up to date with the recent auditing and accounting procedures. For example, after GST was introduced, auditors had to update their knowledge.

4. Work Performed by Others

The scope of audit at times can be very vast. So an auditor has employees, delegates and other people who work under him.

However, the auditor will continue to be fully responsible for the work done by these people working for him. So the auditor must carefully supervise and review such work and be reasonably sure of the accuracy of such work.

5. Documentation

In most cases the auditor maintains an audit notebook, an audit plan and auditing file. It is important the auditor keeps a record of important documents with respect to his audit work, as it is evidence of the work the auditor has done. And the client is inclined to these documents and files if he wishes to inspect the work.

6. Planning

An audit plan allows the auditor t plan out his work and enables him to be more efficient and timely. Every audit plan is different as it has to be customized according to the type of organization, the kind of business they conduct, the scope of the audit, the efficiency of the internal controls etc.

7. Audit Evidence

The auditor must collect enough evidence to support his final opinion. This collection of such evidence is done by compliance and substantive procedures. There are two sources of this evidence – internal and external. Also, external sources of evidence are always more reliable.

8. Accounting Systems and Internal Controls

The auditor has to assure that the accounts of the organization are accurate and represent a true and fair picture of the financial status of the company. Also, the auditor must ensure that all material information has been recorded in the accounts. Testing the internal controls system is also important as it helps determine the same.

9. Audit Conclusions and Reporting

After the auditor collects all evidence he must now form his opinion on the basis of the following criteria,

•All relevant accounting standards were applied at all times

•Financial statements are in compliance with all regulations and statutory requirements

•All material information has been disclosed

Book-Keeping, Accountancy and Auditing

Book-Keeping, Accountancy and Auditing are the three aspects of the term ‘Accountancy’ itself in its widest sense. Book-keeping is the art of recording the daily transactions in a set of financial books. It is concerned with systematic recording of transaction in the books of original entry and their posting into ledger. A person with the knowledge of rules of journalizing and posting can very easily do the job. In some countries like Africa & England, this work is done by machines.

Accountancy

Accountancy begins where book-keeping ends.” It means that an accountant comes into the picture only when the book keeper has done his job. The functions of accountant can be classified as under :

- Checking the work of book-keeper.
- Preparation of trial balance,
- Preparation of Trading and Profit and loss Account.
- Preparation of balance sheet,
- Passing entries for rectification of errors and making adjustments.

An accountant is supposed to be an expert in the accounting procedures as he has to examine analytically the final accounts. But it is not necessary for him to pass the chartered Accountant’s examination. He it’s not supposed to submit his report after the completion of work.

Auditing

It is said, “Where accountancy ends, auditing begins.” It is sightly said. An auditor has to verify the entries passed by the accountant and the final accounts prepared by him. Thus, auditing is the checking of the accounts of a business with the help of vouchers, documents and the information given to him and the explainations submitted to him. An auditor has to satisfy himself after due verification and

complete. Checking of accounts as to whether the transactions entered into the books are accurate. An auditer is required to submit his report to the effect whether or not the balance sheet is a true and fair representation of the existing state of affairs of a business concern.

Thus, an auditor should have the proper knowledge of accounting principles. That is why he should be a chartered Accountant. He has to express his impartial opinion in his report which he can not give unless he satisfies himself completely with the proper recording of transactions. Thus, auditing is based on accountancy and not accountancy on auditing. An auditor must be well familiar with the principles and practical aspects of accountancy but it is not necessary for an accountant to be an expert in the audit work.

Objectives of Auditing:

The objectives of auditing are changing with the advancement of business techniques. Earlier it was only to check the correctness of receipts and payments. The objectives of the auditing have been classified under two heads:

- Main objective
- Subsidiary objectives

•Main Objective:

The main objective of the auditing is to find reliability of financial position and profit and loss statements.

- to ensure that the accounts reveal a true and fair view of the business and its transactions.
- to verify and establish that at a given date 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. It is to be established that accounting statements satisfy certain degree of reliability. Thus the main objective of auditing is to form an independent judgment and opinion about the reliability of accounts and truth and fairness of financial state of affairs and working results.

Subsidiary objectives: The subsidiary objectives of the auditing are:

•**Detection and prevention of fraud:** the one of the important subsidiary objective of auditing is the detection and prevention of fraud. Fraud refers to intentional misrepresentation of financial information. Fraud may involve:

- Manipulation, falsification or alteration of records or documents
- Misappropriation of assets.
- Suppression of effect of transactions from records or documents.
- Recording of transactions without substance.
- Misapplication of accounting policies

The auditor is given a free hand to the books, accounts, statements enabling him to thoroughly check them and if satisfied to certify that books have been properly drawn up and represent a true view of the financial position of the business. He gives his special attention to the direction of errors which may be innocently or intentionally committed.

•**Detection and prevention of errors:** is another important objective of auditing. Auditing ensures that there is no misstatement in the financial statements. Errors can be detected through checking and vouching thoroughly books of accounts, ledger accounts, vouchers and other relevant information. In the case of former the auditor discovers the errors by vouching the transactions and by comparing and tallying the balances between and amongst various books. But in the case of latter such errors are classified as frauds as it leads to defrauding the proprietors. The frauds could be detected by a thorough checking of the books and documents such as cash book, vouchers, invoices, wage sheets, etc.

IMPORTANCE OF AUDITING

The importance of auditing can be summed in following points:

- Audited accounts help a sole trader in knowing the value of the business for the purpose of sale.
- Dispute over correctness of profits can be avoided.
- Shareholders, who do not know about day today administration of the company can judge the performance of management from audited accounts.
- It helps management in detecting and preventing errors and frauds.
- Management gets advice on financial affairs from the auditors.
- Long and short term creditors depend on audited financial statements while taking decision to grant credit to business houses.
- Taxation authorities depend on audited statements in assessing the income tax, sales tax and wealth tax liability of the business.
- Audited accounts are useful for the government while granting subsidies etc.
- It can be used by insurance companies to settle the claims arising on account of loss by fire.
- Audited accounts serve as a basis for calculating purchase consideration in case of amalgamation and absorption.
- It safe guards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

DIFFERENCE BETWEEN ACCOUNTING ANDAUDITING

Basis for Comparison	Accounting	Auditing
Meaning	Accounting means systematically keeping the records of the accounts of an organization and preparation of financial statements at the end of the financial year.	Auditing means inspection of the books of account and financial statements of an organization.
Governed By	Accounting Standards	Standards on Auditing
Work performed by	Accountant	Auditor
Purpose	To show the performance, profitability and financial position of an organization.	To reveal the fact, that to which extent financial statement of an organization gives true and fair view.
Start	Accounting starts where bookkeeping ends.	Auditing starts where accounting ends.
Period	Accounting is a continuous process, i.e. day today recording of transactions are done.	Auditing is a periodic process.

Classification of Auditing:

1. Continuous Audit: This is useful in case of big companies with larger business which have scope for keeping the audit staff busy year round or auditors may attend to auditing at intervals fixed or otherwise, and perform an interim audit. In this case, routine business goes on simultaneously with the audit work.

2. Periodical or Final Auditing: After the completion of the financial year audit work is undertaken which goes on continuously till its completion. This system is the most satisfying from the auditors point of view.

Advantages of Auditing

Assurance to the Owners/Investors One of the biggest advantages of auditing is that it offers assurances to the owners, investors, shareholders etc. The owners of the business will be assured about the accuracy of their books of accounts.

They will be satisfied with the workings of their various departments and the overall efficiency and profitability of their business operations. It is the same case with investors, who will find assurance in the books of accounts after auditing.

Errors and Frauds An error is something that is done without the intention to fraud the company, it is an innocent mistake. Fraud, on the other hand, is deliberate. During the process of auditing, both errors and frauds are discovered. Auditing also helps prevent such errors and frauds. It creates a fear of being detected.

So auditing helps us minimize the risks of errors and frauds in our books of accounts but does not eliminate the risk entirely. There is always the chance that the error may go unnoticed, and the fraud is very cleverly hidden so may go undetected.

Independent Viewpoint If the auditor is an external auditor, the business can get a second opinion on their financial statements and their financial standing as well. An external auditor will closely inspect the books and be completely true and fair in his opinion as he has no hidden agenda. If he says the accounts are true and fair, it has a lot of weightage with the company and the investors.

Moral Check One of the other advantages of auditing is that the staff and the workers of the company do not try to steal or defraud the company. They are under constant scrutiny since they know that the accounts will be audited. Any irregularities can be identified during such an audit, and they will be caught eventually. This helps the staff in being honest and responsible at all times.

Stakeholders Confidence After auditing stakeholders like creditors, investors, banks, debenture holders etc. can rely on the books of accounts with more confidence. And so after auditing by an independent authority, the financial statements have more credibility.

Limitations of Auditing

Cost Factor

A very thorough and detailed audit would be a costly affair. It is not cost effective. So the auditor has to limit the scope of his audit and use techniques like sampling and test checking.

Time Factor

Auditors generally work on a very specific timeline. Sometimes this is due to statutory requirements. This means he has to audit a whole year's accounts in a few weeks. Hence insufficient time is one of the main limitations of auditing.

Inconclusive Evidence

Generally, the audit evidence the auditor collects is persuasive in nature, not conclusive in nature. So there is never cent percent conclusive evidence in most cases while auditing.

This is one of the major limitations of auditing. There also a lot of use of estimates in accounting. The auditor cannot measure or comment on the exact accuracy of these estimates. He has to rely on his knowledge.

Audit and Investigations

There is a lot of difference between auditing and investigation which is as follows :

(a)Audit is conducted to find out whether the balance sheet is properly drawn up and exhibits a true and fair view of the state of affairs of the business while investigation means a searching enquiry with certain object in view, e.g.; to find out the profit earning capacity, or the financial position of a concern or a fraud and the extent thereof.

(b)Investigation covers several years, say, 3,5, and 7 years to find out the average earning capacity, financial position, etc. of a concern while audit usually relates to one year.

(c)Investigation may be carried out on behalf of outsiders who either want to purchase the business, to become partners, to advance loans or to purchase the shares of a firm. Audit is always conducted on behalf of proprietors only. However investigation may also be carried out on behalf of proprietors in case fraud is suspected.

(d)Audited accounts are further investigated for some special purpose in view while investigated accounts are not audited in the ordinary course.

(e)Audit is legally compulsory, specially in case of companies, but investigation is voluntary and depends upon the necessity of some purpose in view.

Objects of an Audit

The main object of audit is to verify the accounts and to report whether the Balance Sheet and the Profit and Loss Account have been drawn up properly according to the companies Act and whether they exhibits a true and fair view of the state of affairs of the concern. For this, an auditor has to discover errors and frauds. As such the subsidiary objects of audit are :

- Detection and Prevention of errors,
- Detection and Prevention of frauds.

The difference between an error and fraud is that error generally arises out of the innocence or carelessness on the part of those responsible for the preparation of accounts, while fraud involves some intention to gain out of manipulating records.

Types of Errors

- **Clerical Errors :** Clerical errors are those which result on account of wrong posting that is posting an item to a wrong account, totalling and balancing. Such errors may again be subdivided into:
- **Errors of Omission :** An error of omission takes place when a transaction is completely or partially not recorded in books of account. For example, goods purchased from Narendra Kumar were not recorded any where in account books. This error will not affect the agreement of Trial Balance. But if posting is not done in one of the accounts, this will affect the agreement of Trial Balance.
- **Errors of Commission :** Errors of commission take place when some transaction in incorrectly recorded in books of account. Following are the examples of such errors :

  (i)Error in the books of Original Entry.

  (ii)Debiting or crediting one account instead of the other.

These two errors do not affect the agreement of Trial Balance,

  (i)Wrong balancing of an account.

  (ii)Error in writing amount in an account. For example, debiting Prem Chand’ s Account with Rs. 107- instead of Rs. 100/-.

  (iii)Casting of the same amount to two accounts.

  (iv)Posting of an amount on the wrong side.

  (v)Posting in one account and omitting of posting in the other account.

  (vi)Error in carrying forward the total of a subsidiary book or an account from one page to the other.

These errors affect the agreement of Trial Balance.

Errors of principle : Errors of Principle take place when a transaction is recorded without having regard to the fundamental principles of book-keeping and accountancy. For example a capital expenditure, say expenses incurred in constructing a godown, may be treated as a revenue expenditure or vice versa, Sometimes adjustments are not taken into consideration while preparing Final Accounts. These are errors of principle. These errors, however, do not affect the agreement of the Trial Balance.

•**Compensating Errors** :- Compensating errors arise when an error is counter balanced or compensated by any other error so that the adverse effect of one on debit (or credit) side is neutralised by that of another on credit (or debit) side. For example Rani's account was to be debited with Rs. 10, but it was debited with Rs. 100 similarly Shyam's account was debited with Rs. 10 instead of Rs.

•Both these errors compensate each other's deficiency and will not affect the agreement of the Trial Balance.

Detection of Errors :- Although it is not the duty of the auditor to trace and locate errors in the books which he is required to check and audit as this is the work of an accountant but in many cases the auditor is frequently asked to discover the errors, specially so, when the accountant is unable to locate such errors. While locating errors, the auditor should take note of following devices.

Detection and Prevention of Fraud

Fraud means false representation or entry made intentionally or without being in its truth with a view to defraud somebody. Detection of fraud is considered to be one of the important duties of an auditor.

Fraud may be of three types

•***Misappropriation of Cash*** **:** It is easier to misappropriate cash, therefore the auditor will have to pay particular attention towards cash transaction. Cash may be misappropriated by,

•Omitting to enter any cash which has been received; or

•Entering less account than what has been actually received; or

•making fictitious entries on the payment side of the cash book; or

•entering more amount on the payment side of the Cash Book than what has been actually paid. In order to discover fraud under (a) and (b) above, the auditor should check the debit side of the cash book with rough cash book, salesmen's reports, counterfoils of the receipt books, agent's returns and other original records while the fraud under (c) and (d) can be discovered by reference to the vouchers, wage sheets, salary book invoices, etc.

•**Misappropriation of Goods :-** This type of fraud is very difficult to detect especially when the goods are less bulky and are of higher value. Proper methods of keeping accounts in regard to purchases and sales, stock, taking, periodical checking of stocks, comparing the percentage of gross profit to sales of two periods, necessity for collusion will help to avoid misappropriation of goods.

•**Fraudulent Manipulation of Accounts :** This type of fraud is more difficult to discover as it is usually committed by directors or managers or other responsible officials. That is why the auditor should be very careful in detecting such frauds. He should carry out the routine checking and vouching most carefully and make searching, tactful and intelligent enquiries. Such a fraud is committed with the following two objects :-

•Showing more profits than what actually they are so as to increase the commission payable on the basis of profits, borrow money by showing a better position, to attract more subscribers for the sale of the shares of the company etc. or

•Showing less profits than what actually they are so as to purchase shares in the market at a lower price ; or to reduce or avoid the payment of income tax or to mislead a prospective buyer of the business etc.

Limitations of Auditing

Truly speaking an audit should have no limitation of its own. It is designed to protect the interest of all parties who are interested in the affairs of the business. If these is any short coming arising there from, it may be due to its narrow scope of application in its related field of operations and un-extended designition of the concept. The audit has following limitations.

- **Lack of complete picture**—The audit may not give complete picture. If the accounts are prepared with the intention to defraud others, auditor may not be able to detect them.
- **Problem of Dependence—**Sometimes the auditor has to depend on explanations, clarification and information from staff and the client. He may or may not get correct or complete information.
- **Existence of error in the audited accounts**—Due to time and cost constraints, the auditor can not examine all the transactions. He uses sampling to check the transactions. As a result, there may be errors & frauds in the audited accounts even after the checking by the auditor.
- **Exercise of judgement**—The nature, timing and extent of audit procedures to be performed is a matter of professional judgement of the auditor. The same audit work can be done by two different auditors with difference in sincerity & personal judgement.
- **Diversified situations**—Auditing is considered to be a mechanical work. Auditors may not be in a position to frame audit programme which can be followed in all situations.
- **Lack of Expertise**—In some situations, an auditor has to take opinion of experts on certain matters on which he may not have expert's knowledge. The auditor has to depend upon such reports which may not be always correct.
- **Limitations of internal control**—The auditor can only report on the truth and fairness of the financial statements. But other problems relating the management and control may not be possible to be covered by the auditor. Examples of such problems or limitations of internal control are cast-ineffectiveness, manipulations by management, etc.
- **Influence of management on the auditor**—This is also come of the limitations of the audit that the auditor is influenced by the doings of those in management. The reason is that he is appointed by the share holders and directors who pay him remuneration or fee.

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

- **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:

1. **Company Audit:-** The audit of joint stock companies compulsory under the companies act. For the first time the Indian Companies Act, 1913, made it legally compulsory for joint-stock companies in India to get their accounts audited by an independent professional accountant, but now, the companies Act, 1956 and subsequent amendments have made tremendous changes in the rights, duties, powers etc., of an auditor.
2. **Audit of Trusts :-** Trust are usually created for the benefit of the weak and helpless persons like widows, minors etc., who are not in a position to have access to and understand the accounts of such trusts. Therefore the trustees are made responsible to look after the property and to maintain accounts. But in a large number of cases, the trustees either do not maintain accounts at all or if they are forced to do so, such accounts are very often misleading. To avoid such a situation specific provisions are sometimes made in the trust deed for the appointment of auditors to check the accounts of the trusts. In some of the state in India,
3. **Audit of other institutions :-** There are other corporate bodies such as electricity and gas companies which has been formed under their respective statutes. There is another set of public bodies in the name of public corporations, for example, Reserve Bank of India, Industrial Financial Corporation, etc.; Which work according to the various Acts passed for the purpose. All these institutions fully recognise the significance of a professional audit which is compulsory for them.

- **Private Audit:** The institutions which are private in character also get their accounts audited by some qualified auditors. As such an audit is not required by statute, it is known as private audit. There may be three types of such institutions which are as follows :
  1. **Audit of the accounts of Sole Trader :-** The appointment of an auditor in case of a proprietary concern rests absolutely on the proprietor. His rights, duties and nature of work will depend upon the terms given in the agreement. Such an auditor must get clear instruction in writing by his client as to what he has to do and how he has to proceed so that he can be held responsible for any charge of negligence and by producing the agreement, he can protect himself against such a charge.
  2. **Audit of the Accounts of partnership Firms** *:-* In case of a partnership firm, the auditor is appointed by agreement between the partners. His rights, duties and liabilities are also defined by mutual agreement and can be subjected to modification.
  3. **Audit of the accounts of other individuals and institutions :-** There are other individuals, e.g., rent collectors, estate managers, etc., who have large income and huge expenditure. The qualified auditors are appointed by these individuals in order to verify various accounts prepared by the accountants.
- **Government Audit:** The Government maintains a separate department in the name of accounts and audit department which performs the audit of its different departments and offices. This department is headed by the Comptroller and Auditor General of India who is assisted by different officials at various levels.

The duties and liabilities of such auditors are not defined by statue. They are not public auditors and hence can not be appointed auditors for public concerns. They are meant for Government departments and as such, they work according to departmental rules and instructions.

• **Internal 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. Such auditors are of a permanent nature and are known as internal auditors. Such auditors, besides checking the accounts are required to report also as to how the system of accounting can be improved and the system of internal check be made economical and efficient. They can not be appointed as public auditors or external auditors and hence are not required to submit their reports in the manner in which external auditors do.

In short internal audit is the examination of books of account which is conducted by the salaried officials of a business known as internal auditors throughout the year. The scope of internal audit is a bit different. It is more closely related to managerial functions than to accounting duties.

From Practical Point of View :

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

- Continuous Audit or Detailed Audit.
- Periodical audit or Final Audit or complete Audit.
- Interim Audit.
- Occasional Audit.
- Partial Audit.
- Balance Sheet Audit.
- Cash Audit.
- Cost Audit.

Qualities of an Auditor:

The Auditor must possess the following qualifications and qualities:

1. Only the qualified chartered accountant can be appointed as auditor of a limited company.
2. The auditor must have thorough knowledge of principles and practice of all aspects of accountancy. He must be familiar with all systems of accountancy in use.
3. He should have adequate knowledge of financial management, industrial administration and business organization.
4. He must have thorough knowledge of audit case laws as per the various cases decide by the courts in and outside India.
5. He should be able to understand the technical details of business whose accounts he is going to audit.
6. An auditor must be honest i.e. He must certify that he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true.
7. He must act impartially and not influenced by others, directly or indirectly while discharging his duties.
8. He should be hard working, systematic and methodical.
9. He must have capacity to hear arguments of others.
10. He should have adequate skills and courage to write audit report correctly clearly and concisely.
11. He should not disclose the secrets of his client.

Appointment of an Auditor

Appointment of Auditor in case of Sole proprietor: The appointment of Auditor in case of sole trader is done by the owner of the business. In case of sole traders the auditor generally acts as an accountant who also prepares accounts besides checking their accuracy. As He is appointed by an individual he must get clear instructions from his client in writing as to what he is expected to do. His work and its scope will depend upon the agreement with his client since the appointment of an auditor is not under any statute, therefore the rights and the duties will depend upon the agreement.

Appointment of Auditor in case of partnership: The Auditor of a partnership firm is made by the mutual consent of all the partners

Appointment of Companies Auditors: The provisions regarding appointment of the auditor are contained in section 139 of Companies Act 2013

Appointment of auditor by members [sec 139(1)]:

A company shall appoint an individual or a firm as an Auditor at the first annual general meeting and each subsequent sixth annual general meeting.

Such auditors shall hold office till conclusion of sixth annual general meeting.

Such appointment shall be placed before the members at each annual general meeting for ratification.

Period for which the appointment is made [sec 139(2)]:

An individual can be appointed for a term no more than five years.

An audit firm can be appointed for a consecutive term not more than two terms of five years.

An individual or a firm which has completed its term shall not be eligible for reappointment as auditor in the same company for five years from the completion of term.

Appointment of auditor of Government companies (sec 139 (5)): The comptroller and Auditor general shall in respect of financial year appoint an auditor duly qualified within 180 days from the commencement of financial year who shall hold office till conclusion of annual general meeting.

Appointment of First Auditor by Board of Directors [sec139 (6)]: The first auditor of a company other than government company shall be appointed by the board of directors within 30 days of registration of company. If the board fails to appoint first auditor it shall inform the members of company who shall appoint auditor within 90 days at extra ordinary general meeting who shall hold the office till conclusion of first annual general meeting.

Appointment of First Auditor of Government Company [sec 139 (7)]: The first Auditor of a Government Company shall be appointed by Comptroller and Auditor general within 60 days of registration of company. In case of its failure to appoint first auditor, then board of directors shall appoint auditor within next 30 days. The company shall inform the members if the board fails to appoint first auditor who shall appoint the auditor within 60 days at extra ordinary general meeting who shall the office till conclusion of the first general meeting.

Casual vacancy of an Auditor [sec 139 (8)]

The casual vacancy of auditor, except in case of Government Company, shall be filled by the board of directors within 30 days but if it arises as a result of resignation of the auditor it shall be approved by company at general meeting convened within 3 months o recommendation of board. Such auditor shall hold office till conclusion of next annual general meeting.

Casual vacancy in case of Government Company shall be filled by Comptroller and Auditor General within 30 days if he fails to fill the vacancy, the board shall fill the vacancy within next 30 days.

Reappointment of a retiring auditor [sec 139 (9)]:

Such an auditor can be reappointed at annual general meeting if.

He is not disqualified for reappointment.

He has not given notice to company of his unwillingness.

A special resolution has not been passed at annual general meeting appointing some other person or providing expressly that he shall not be reappointed.

All the above is subject to the provisions of sec 139 (1)

Qualifications of an Auditor:

1. A person shall be eligible for the appointment of an auditor of a company only if he is a chartered accountant.
2. Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of firm.

Disqualifications of an Auditor:

The following persons shall not be eligible for the appointment as an auditor of a company:

1. An officer or employee of the company.
2. A person who is a partner, or who is in employment or an officer or employee of the company.
3. A person or a firm who, whether directly or indirectly has business relationship with the company, or subsidiary of such holding company or associate company of such nature as may be prescribed.
4. A person whose relative is director or is in the employment of the company as director or key managerial personnel.
5. A person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies.
6. A person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction.

Remuneration of an Auditor (sec 142)

•The remuneration of the Auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.

•The Remuneration under sub section (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the facility extended to him but does not include any remuneration paid to him by any other services rendered by him at the request of the company.

Removal, Resignation of an Auditor

•The Auditor appointed under section 139 may be removed from his office before expiry of is term only by a special resolution of the company after obtaining the previous approval of the central Government.

•The Auditor who resigns from the company shall file within a period of thirty from the date of resignation, a statement in a prescribed form with the company a registrar, the auditor shall also file such statement with the comptroller and auditor –general indicating the reasons and other facts as may be relevant with regard to his resignation.

Rights of an Auditor

1. **Right to Access books of accounts**: Every auditor of a company has right to free and complete access at all the times to the books, accounts and vouchers of the company
2. **Right to obtain the information and explanation**: An auditor is authorized to obtain such information and explanation as the auditor may think necessary for the performance of his duty as auditor.

3. Right to receive notice: All notices of the company and other communications relating to any general meeting of the company shall be forwarded to the auditor of the company. He is also authorized to attend the meetings and make any statement or explanation with regard to the accounts audited by him.

4. Right to sign audit report: only the person appointed as auditor of the company, where a firm so appointed only a partner in the firm practicing in India, may sign the auditor's report or authenticate any other document of the company required law to be signed or authenticated by auditor.

5. Right to seek legal and technical advice: The auditor of a company is entitled to seek the legal and technical advice which may be needed in the performance of his duties.

6. Right to remuneration: on completion of his work an auditor is entitled to his remuneration.

7. Right to be indemnified: for many purposes, an auditor is considered to be an officer the company. An officer has a right to be indemnified out of the assets of the company against any liability.

Duties of an Auditor: Duties under section 143 (1):

1. The auditor has a duty to enquire whether loans and advances made by the company have been properly secured whether the term and the conditions there of are prejudicial to the interest of the company or its members.
2. Duty to enquire whether assets of the company being shares or debentures and other securities have been sold at a price less than at which these were purchased.
3. Whether any shares have been allotted for cash, whether cash actually received and whether the position in the account books and balance sheet is correct, regular and not misleading.

Duties under section 143 (2):

The auditor has the duty to report the members of the company, the accounts examined by him and every financial statement to be laid before the company in the general meeting. The auditor shall state in his report to the best of his information and knowledge, the said accounts and financial statements whether give a true and fair view or not, of the state of company's affairs

Duties under section 143(3):

1. He has the duty to sought and obtain all information and explanation which are necessary for his audit.
2. He has a duty to ensure that the books of accounts as required by law have been kept by the company.
3. He has a duty to see whether the company has adequate internal financial control systems in place and their operative effectiveness.
4. He has a duty to ensure whether the company's balance sheet and profit and loss account dealt within the report or in agreement with the books of account and returns.

Liabilities of an Auditor:

1. Civil liabilities 2. Criminal Liabilities

Civil Liabilities:

(i) Liability for Negligence: The liability of an auditor arises where it is proved that his client has suffered a loss due to his professional negligence. The auditor may be held personally liable, if it is proved, that had he exercised reasonable care and skill, he must have discovered the discrepancy. In a case it was held that if an auditor fails to show as much skill and diligence as is expected of a man of ordinary prudence, he must suffer the consequences.

(ii) Liability for misfeasance: According to section (340), the court may assess damages against delinquent director and other officers of the company, including an auditor for misfeasance or breach of trust. In case of an auditor who also comes within the definition of officer in section 2 (59) for purpose of the section, if he is guilty of neglect of duty or misfeasance, so as to cause loss of company in any way, proceedings may be taken under this section against him either independently or other officers or jointly with them. This section provides a simple way to the company to recover damages where an auditor or any other officer of the company is guilty of misfeasance. The time limit for bringing an action is 5 years.

Criminal Liabilities:

Mis-statement in prospectus section 34: Where an auditor makes false statement with material particulars in returns, reports, prospectus or other statements knowingly it to be false or omits any material facts knowing them to be false, he shall be punishable with imprisonment for a minimum term of 6 months extendable to 10 years.

Non compliance by auditor with section 143 and 145: If the auditor does not comply with section 143 and 145 regarding making his report or signing or authentication of any document and makes willful neglect on his part he shall be punishable with imprisonment up to 1 year and with fine not less than twenty thousand extendable to five lakhs.

In case an auditor knowingly or willfully with the intension to deceive the company or shareholders or creditors or tax authorities, he shall be punishable with imprisonment up to 1 year and fine not less than 1 lakh extendable up to twenty five lakhs.

Failure to assist in the investigation section 217 (6): Where the central Government appoints an inspector to investigate the affairs of the company, it is the duty of the auditor to preserve and produce to the inspector all books and papers relating to the company. If an auditor fails to assist the inspector in investigation he shall be punishable with imprisonment up to 1 year and with fine not less than twenty five thousand extendable to 1 lakh.

Penalty for falsification of books section 336: Any officer including auditor of a company which is being wound up, with an intention to defraud or deceive any person, destroys, mutilates, alters, falsifies any books, papers or securities. He shall be punishable with imprisonment fora term not less than 3 years extendable to 5 years and with fine not less than 1 lakh extendable to three lakhs.

Penalty for deliberate act of commission or omission section 448: If any officer including auditor of the company deliberately make a statement in any return, report, certificate, balance sheet, prospectus etc. which false or which contains omission of material facts he shall be punishable with imprisonment for a term not less than 6 months extendable to 10 years and fine not less than amount involved in fraud extendable to 3 times of such amount.

UNIT - 2

INTERNAL CHECK: Meaning and Definition – Internal Audit - Internal Control – Internal Check Vs. Internal Audit – External Audit Vs. Internal Audit – Audit Programme – Audit Note Book – Audit working Papers

INTERNAL AUDITING :

Internal auditing is an independent, objective, assurance and consulting activity that adds value to and improves an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

TYPES OF INTERNAL AUDITS:

Compliance Audits evaluate compliance with applicable laws, regulations, policies and procedures. Some of these regulations may have a significant impact on the company's financial well-being.

Environmental Audits assess the impact of a company's operations on the environment. They may also assess the company's compliance with environmental laws and regulations.

Information Technology Audits may evaluate information systems and the underlying infrastructure to ensure the accuracy of their processing, the security and confidential customer information or intellectual property. They will typically include the assessment of general IT controls related logical access, change management, system operations, and backup and recovery.

Operational Audits assess the organization's control mechanisms for their overall efficiency and reliability.

Performance Audits evaluate whether the organization is meeting the metrics set by management in order to achieve the goals and objectives set forth by the Board of Directors.

Who Performs the Audit?

- **Internal Audits** – Internal Auditors, typically employees of the company
- **External Audits** – External Auditors, typically members of a CPA firm

Who is the Audit Reported to?

- **Internal Audits** – Board of Directors, and members of management
- **External Audits** – Shareholders and members outside of the company

What Does the Audit Cover?

- **Internal Audits** – Internal Controls related to:
  - Governance
  - Risk Management
  - Process Improvement
- **External Audits** – Financial Reports, and Internal Controls related to Financial Reporting.

When are Results Reported by the Audit?

- **Internal Audits** – May report at any frequency designated by the Board
- **External Audits** – Annually

INTERNAL CONTROL:

Internal Control comprises of the plan of the organization 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. It covers the whole management system of an organization, both financial ornon-financial.

There are two types of controls:

Financial Control

Administrative Control.

Characteristics of Internal Control:

- Competent and trustworthy personnel
- Records, Financial and other Organization plan
- Organizational plans
- Segregation of duties
- Supervision
- Authorization
- Sound practice
- Internal Audit
- Arithmetic and accounting controls

LIMITATIONS OF INTERNAL CONTROL:

a. Management decision to choose cost effective control system may reduce the effectiveness of internal control system.
b. There are chances of misuse by a person of authority who is operating on internal control system.
c. Objectives of internal control systems may be defeated by manipulation of management.
d. Since internal control system is involved in routine transactions, irregular transactions may be overlooked.
e. Changes in conditions may affect the effectiveness of internal control system.

SCOPE OF INTERNAL CONTROL

Cash :

Here, internal control is applied over payments and receipts of an organization. This is to safeguard from misappropriation of cash.

Control over Sale and Purchase :

With proper and efficient control system for transactions regarding purchase and sale of material, handling of material and accounting for the same is must.

Financial Control :

It deals with the efficient system of accounting, recording and supervision.

Employee's Remuneration :

Internal control system is applied to preparation and maintenance of records of employees and the payment methods also. It is also necessary to safeguard against misappropriation of cash.

Capital Expenditure :

Internal control system ensures the proper sanction of capital expenditure and also the use of it for the purpose intended.

Inventory Control :

It covers the proper handling of inventory, minimization of slow moving items or dead stock, proper valuation of stock, recording of it, etc.

Control over Investments :

Internal control system is applied to the proper recording of transactions be it purchases, additions, sale or redemption, income on investments, profit or loss on investment.

Essential Characteristics of Internal Check System

1.Division of Work:

No one should be allowed to have the right to perform the work from origin to end.

For example – a transaction of sale may have to be split into a display of article by staff, the preparation of invoice by another, the receipt of cash against the invoice by a third clerk, the delivery of article against the proof of receipted invoice by another clerk, checking of outward movement of an article against delivery order by a clerk and so on.

2.Provision of Check:

An organization should set up such provisions so that work can be checked by another staff. An officer can check the work of one staff by transferring to the staff and again.

3.Use of Devices:

In this modem world, various devices can be used to do various functions like the use of time record machines, wage determination machines, etc. An organization should use machines that help to make work of internal check easier.

4.Self-balancing System:

An organization can use self-balancing ledger accounts, which help to make the work of internal check easier. Its effectiveness depends on its management.

5.Job Rotation:

No individual clerk should be allowed to occupy a particular area of operation for long. Familiarity with and exclusiveness in a position offer a person greater flexibility to attempt manipulation with the system.

6.Specialization:

Every staff may not have such specialized knowledge to maintain accounts properly. So, an organization should give the training to increase their skills so that internal checks can be made more effective.

7.Control:

There is more chance of frauds where there is direct contact between consumers or the public. So, a manager can keep eyes in those works so that the internal check system can be made more effective.

8.Authority Level:

There must be clear cut authority levels according to sanctions to various transactions. Commensurate to the authority vested, responsibility must be extracted. The existence of authority levels results in a review of the operations of subordinates.

Objectives of Internal Check:

There are several objectives of the internal check. They are given below:

- To minimize the possibility of error, fraud, and irregularity.
- To prevent the misappropriation of cash and goods.
- To allocate duties and responsibilities to every clerk in the organization.
- To ensure an accurate recording of all business transactions.
- To enhance the efficiency of the clerk in the organization.
- To exercise moral influence over the staff member.
- To prepare a final account with ease and efficiency.

Advantages of Internal Check:

The main advantages of an internal check are listed below:

1.Moral Influence on Employees:

The system of internal check puts a morale check on members of staff and enables them to learn honesty, hard work, and straightforwardness.

2.Determination of Employees Liability:

The system of the internal check determines the responsibilities of employees. The member of the staff may be held responsible for any irregularity carried on by him.

3.Less Possibility of Frauds:

There is less possibility of fraud under the system of the internal check because errors and frauds can be detected at an early stage.

4.Increase in Efficiency:

The system of internal check ensures greater .efficiency and speed because the arrangement of internal check is based on a division of labor.

5.Auditing Made Easy:

The system of internal check facilitates the work of auditors to a great extent by enabling him to relay on test checking.

6.Final Accounts Can Be Prepared:

In an internal check system, the 'Profit and Loss Account' and Balance Sheet is prepared without any loss of time.

7.Correct and Complete Records of all the Transactions:

The system of an internal check may also result in correct and complete records of all the transactions on each balancing of the books of accounts.

8.Detection of Dishonesty or Irregularity:

Any dishonesty or irregularity in the concern by the members of staff can be detected before they assume any complication.

9.Test Checking Possible:

Suppose the auditor finds the system of internal cheek satisfactory. Then by taking into mind, it defects or weak points he can take the help of test checking.

Disadvantages of Internal Check:

1.Expensive:

The system of Internal Check is more expensive and time-consuming.

2.Slackness in the Work:

This is also a serious defect of the system of internal check. The auditor may show slackness at work. He may rely on the system of internal check blindfold, which may affect the quality of audit work adversely.

3.Not Suitable for Small Concern:

The system of internal check is not suitable for small concern as it may be uneconomical in small concern.

4.Grouping among Employees:

If the employees of the concern join hand, they may keep the employer in the dark and may cause many irregularities defying any-detection thereof.

This groupism amongst the employees may not be healthy.

Principles of Internal Check

An internal check is based on some specific principles. Without which, an internal check is of no use. These principles are given below:

- The process should be allocated among the staff of the business according to the duties, responsibility, and rights in such a. There is no room for interference.
- No single person should have independent control over the all-important aspects of the business.
- The duties among the staff of the business should be changed from time to time so that no staff should be engaged in a particular job for a long time.
- Every member of the staff should be encouraged to go on leave at least once in a year .this will help in detecting concealed fraud.
- An efficient system of internal check should provide for automatic checking of the work of an assistant by others.
- The division of work should not be much expensive.
- The self-balancing system should be invariably used.
- The financial and administrative power should be assigned very judiciously to different officers.
- A person having physical custody of assets must not be permitted to have access to the books of account.

Difference between internal check and internal audit:

BASIS FOR COMPARISON	INTERNAL CHECK	INTERNAL AUDIT
Meaning	Internal Check is a system, wherein division of work and allocation of responsibilities are organized in such a manner that the work of one employee is spontaneously looked over by another.	Internal Audit is the ongoing critical examination of the financial and operational activities of the concern, by an internal auditor.
Method	Work of one person is automatically checked by another person.	Work performed by the employees is examined by a separate group.
Commencement of Work	Commences from the moment a transaction is entered.	Once the transaction has been recorded in the books.
Involved evaluation of	Accounting and clerical accuracy	Effectiveness of management control
Performed by	Existing staff	A specially dedicated team of auditors

Cost Involvement	Economical	Comparatively Expensive
Thrust of System	Prevention of errors and frauds	Detection of errors and frauds
Tool for	Arrangement of the work	Examination of the work
Time of Checking	Checking is performed simultaneously when the work is performed.	Examination of the work takes place after the work is completed.
Report	Summary of day to day transactions acts as a report to the supervisor.	Submits his/her report to the management.

BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
Meaning	Internal Audit refers to an ongoing audit function performed within an organization by a separate internal auditing department.	External Audit is an audit function performed by the independent body which is not a part of the organization.
Objective	To review the routine activities and provide suggestion for the improvement.	To analyze and verify the financial statement of the company.
Conducted by	Employees	Third Party
Auditor is appointed by	Management	Members
Users of Report	Management	Stakeholders

Opinion	Opinion is provided on the effectiveness of the operational activities of the organization.	Opinion is provided on the truthfulness and fairness of the financial statement of the company.
Scope	Decided by the management of the entity.	Decided by the statute.
Obligation	No, it is voluntary	Yes, according to Indian Companies Act, 1956.
Period	Continuous Process	Once in a year
Checks	Operational Efficiency	Accuracy and Validity of Financial Statement

Key Differences Between Internal Audit and External Audit

The following are the major differences between internal audit and external audit:

1. Internal Audit is a constant audit activity performed by the internal audit department of the organisation. External Audit is an examination and evaluation by an independent body, of the annual accounts of an entity to give an opinion thereon.
2. Internal Audit is discretionary, but the External audit is compulsory.
3. Internal Audit Report is submitted to the management. However, the External Audit Report is handed over to the stakeholders like shareholders, debenture holders, creditors, suppliers, government, etc.
4. Internal Audit is a continuous process while the External Audit is conducted on a yearly basis.
5. The purpose of Internal Audit is reviewing the routine activities of the business and give suggestions for improvement. Conversely, External Audit aims at analysing and verifying the accuracy and reliability of the financial statement.
6. Internal Audit provides an opinion on the effectiveness of operational activities of the organisation. On the other hand, External Audit gives an opinion of the true and fair view of the financial statement.
7. The scope of internal audit is decided by Those Charged With Governance (TCWG). As opposed to external audit, whose scope is determined by law.
8. Internal Auditors are the employees of the organisation as they are appointed by the management itself, whereas External Auditors are not the employees, they are appointed by the members of the company.

Definition:

Audit programme may be defined as the auditor's plan of action indicating the work to be accomplished, the audit tests and procedures to be followed, the persons responsible for the accomplishment of the work, and the time within which the work is to be accomplished.

Methods of Audit Programme

1. Complete Programme:

Complete programme is on the file. Completed items are ticked off by the particular assistant. Assistant knows what he has to do. He also knows that by which date each item is to be completed.

2. Individual Programme:

According to the nature of the business auditor prepares the programme for each assistant in such cases.

3. No Any Advance Programme:

In this case auditor never prepares the programme in advance but according the progress of the work he allows to go.

Advantages of Audit Programme

1. Supervision Of Work:

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

2. Distribution Of Work:

Audit programme is very useful in distributing the audit work properly among the members f the audit team according to their talent.

3. Uniformity Of Work:

Audit programme helps in settling all the things in advance, so the uniformity of work can be achieved.

4. Basic Instrument For Training:

Audit programme is very useful for the new auditor. It provides training and guidance to him. So it is rightly called the basic instrument for training.

5. Legal Evidence:

Audit programme is a legal evidence of work done by every assistant of the audit team. It can be presented in the court of law if any client is taken against the auditor for negligence.

6. Fixation Of Responsibility:

If any error or fraud remains undetected the responsibility of negligence will fall on the particular assistant who has performed that job.

7. Several Audits may Be Controlled:

The auditor controls the audit of various companies at the same time. In the absence of audit programme he can not supervise them effectively.

8. Easy Transfer:

If one assistant is unable to continue the work given to him, it can be given to another person. Audit programme guides him that what is done and what is remaining.

9. Final Review:

Before signing the report, final review is made and for this purpose also auditing programme is very useful.

10. Useful For Future:

On completion of an audit, it serves the purpose of audit record which may be useful for future reference.

Disadvantages of Audit Programme

1. Not Comprehensive:

Auditors may have covered the whole field but it can not be said with certainty that all the necessary work have been done.

2. Rigidness:

Audit programme looses its flexibility. While each business have a separate problems. So audit programme can not be laid down for each type of business.

3. No Initiative:

It kills the initiative of capable persons assistant can not suggest any improvement in the plan.

4. Too Mechanical:

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

5. Not Suitable For Small Audit:

It has been proved that audit programme is not suitable for sail audits.

6. New Problems Over Looked:

With the passage of time new problems arise which may be over looked.

Definition of Audit Note Book

E.L. Kohler "Audit note book is a record, used chiefly in recurring audits, containing data of work done and comments outside the regular subject matter of working papers. It generally contains such items as the audit programme, notations showing how sections of the audit are carried out during successive examinations, information needed for the auditor's office and for staff administration, personnel assignment, time requirements and notations for use in succeeding examination".

Contents : An audit notebook generally consists of the following information:

1. The nature of the business and summary of important documents relating to the constitution of the business such as Memorandum of Association, Articles of Association or Partnership Deed, etc.
2. A list of the books of accounts maintained.
3. Particulars as to the system of accounts followed and the system of internal check in force.
4. Names of principal officers, their duties and responsibilities.
5. Progress of audit work together with the dates on which the work was undertaken and completed.
6. Extracts from correspondence with different authorities.
7. Audit programme.

- 7. Audit programme.
- 8. Allocation of work among different audit staff.
- 9. All queries which have not been clarified so far.
- 10. Lists of missing receipts, vouchers, bills, etc.
- 11. Any special point arising during the course of audit to which the attention of the auditor must be drawn.
- 12. Particulars of cash balances, investments, fixed deposits, and the reconciliation statements of principal bank accounts.
- 13. Points to be incorporated in the audit report.
- 14. Points, which need further explanations and clarifications.
- 15. All important matters for future reference at subsequent audits.
- 16. Information of permanent nature relating to the business and notes of all important technical transactions.
- **Importance of Audit Note Book**
- 1. Audit note book shall be taken as reliable evidence even by the Court of law in case of dispute or if the auditor is charged with negligence.
- 2. It is useful for drawing the audit programmes.

Advantages of Audit Note Book

Some the advantages of audit note book are given below:

1. Audit note book enables the auditor to record important points, which arise during the course of his audit; otherwise he might forget these points.
2. An auditor can produce this book as a documentary evidence in a suit filed against him for negligence or misfeasance.
3. It facilitates the preparation of the audit report.
4. If the assistant in charge is changed before the completion of a particular work, it acts as a guide and makes the completion of balance work easier.
5. A credit note book makes the work of audit convenient because all the important details about audit can be recorded in this book and, as such, any change in the staff of the auditor does not disturb or dislocate the work of audit.
6. It can help in making an assessment of the work of audit clerks.
7. It provides a key to evaluate the efficiency of the audit staff.

Disadvantages of Audit Note Book

1. Very often, it creates misunderstanding between the client staff and the audit staff.
2. If it is not properly and carefully prepared it cannot be used as evidence against the auditor for negligence.
3. It develops a fault finding attitude in the minds of the staff of the audit.
4. Audit staff has to depend too much upon the client's staff for its preparation.

AUDIT WORKING PAPER

Definition:

Audit working papers refer to the documents that prepare by or use by auditors as part of their works. Those documents include the summary of the client's nature of the business, business process flow, audit program, documents or information obtained from the client as well as audit testing documents.

Audit working papers are sometimes referred to audit documents that they are very imported part of audit works. These documents are evidence that supports auditors to make their conclusion on the financial statements.

Objectives of audit working papers

1. The working papers serve the auditor both as useful audit tool as well as a permanent record of the audit work performed.
2. They are useful to the auditor to control the current year's audit work.
3. They constitute a reliable guidance for planning the future audit assignments.
4. A review of the audit working papers gives an assurance that the audit work is both accurate and complete.
5. The auditors arrange the data properly in the working papers. Hence, the data become more meaningful and useful for the purpose of the audit.
6. Working papers are necessary to corroborate the work and the findings of all the audit staff.
7. The chief auditor is assured that the opinion is supported by the findings of their audit staff.
8. The working papers constitute complete and conclusive evidence in future as to the entirety and completeness of the audit work.

Contents of audit working papers:

1. Schedule of debtors and creditors.
2. Trial Balance.
3. Certificate of officials regarding certain important matters like bad debts, valuation of stock, unpaid expenses, accrued incomes, etc.
4. Statement of depreciation.
5. Correspondence between the auditor and the debtors, creditors, etc. of the client.
6. Investment Schedules.
7. Confirmation by the bank regarding the bank balances of the client.
8. Bank Reconciliation Statement.
9. Important extracts from the minute books such as agreement with vendors, hire purchasers, selling agents, etc.
10. Detail of cash balance checked.
11. Adjustment entries.
12. Contingent liabilities certified by the management.
13. Draft financial accounts.
14. Details of clarifications made during the course of audit.
15. A copy of the auditor's book.

Unit - 3

VOUCHING

Definition : Vouching, widely recognized as—the back bone of auditing, ‖ is a component of an audit seeking to authenticate the transactions recorded in a firm‘s book of accounts. When an accounting transaction is vouched, it is tested and verified by presenting relevant documentary evidence.

OBJECTIVES OF VOUCHING

1. All the transactions which are connected with the business have been recorded in the books of accounts properly.
2. To verify that all transactions recorded in the books of accounts are supported by documentary evidence.
3. The vouchers which support the entries are legally valid from the view point that they are authentic, addressed to the business and properly dated.
4. To verify that no fraud or error has been committed while recording the transaction in books of accounts.
5. The vouchers have been processed carefully through various stages of internal check system.
6. While recording the transaction whether distinction has been made between capital and revenueitems.
7. Whether accuracy has been observed while totaling, carrying forward and recording an amount in theaccount

VOUCHING OF CASHTRANSACTIONS:

How to vouch various cash receipts (Receiptside) Cash sales:

In vouching cash sales, cash register should be fully checked with carbon copies of cash memos. Then, the auditor should verify the daily deposits of cash received in the bank dates of the cash and the date on which the receipts are recorded in cash book must be same. Where the cash memos are cancelled, all copies including the original copy duly cancelled should be kept in the book. Where a company has a discount policy, if more discount is allowed in a transaction it must be approved by a responsible officer.

Cash received from the debtors:

The auditor should verify amount received from debtors from the counterfoils or carbon copies of the receipt issued to the customers. All these receipts should be serially numbered. Amount should be entered in the cash book on the day when received. Discount allowed to customers should be authorized by a responsible officer. Some times correspondence made with customer can also be verified.

Loans:

While vouching the loans received, the terms and the conditions contained in the agreement should be verified. If the loan is secured what security has been offered, whether the fact has been disclosed in the balance sheet.

Bills receivable:

Bills receivable book maybe verified because the various details regarding the bills matured and discounted are available in it. Auditor should check the amount received with the bank statement.

Sale of Investment:

If the sales have been affected through a bank, the auditor should examine the bank advice to know the various details. Sometimes the investment is sold through the broker. Broker's sold note or commission should be examined to verify the sale proceeds and commission charged by the broker. If the investments are sold at cum-dividend price, auditor should see that proper apportionment has been made between capital receipts and revenue receipts. Sometimes the investments are made against specified funds. Profit or loss on sale of such investments must be transferred to such funds account.

Sale of Fixed Assets:

Sale of fixed assets may be vouched with minute book of board of directors, correspondence, agents‘ sale account and sale contract. It should be seen that proper account has been credited. Any profit arising on the sale of asset shall be credited to revenue account which is not available for distribution of dividends. If any expense on the sale of assets is paid, the sale proceeds of the asset should be reduced by such amount and the balance should be credited to asset account. It must be seen that sale of fixed assets has been sanctioned by the authorized person or committee.

Bought Ledger or Purchase Ledger

This ledger contains accounts relating to creditors. The auditor should take the following steps:

- He should check the opening balances of different accounts with the audited balance sheet of the previous year.
- He should examine all supporting books like purchases book, goods inwards book, cash book, discount register, goods outward book etc.
- If the self- balancing system is in use, he should ask his client for a schedule of creditors and total of the schedule should be tallied with the creditor's ledger adjustment account.
- The auditor should examine all the creditors statements and with their help, the purchase ledger balances should be checked.
- He should see that the balances in the purchases ledger whether debit or credit are shown on the proper side of the balance sheet.
- He should ensure that provision for reserve for discount on creditors, if made, isnot excessive.

Sales Ledger or Debtors Ledger

This contains accounts relating to debtors.

The following points should be noted while vouching sales ledger:

- The auditor should check the opening balances with the audited balance-sheet of the previous year.
- He should examine supporting book like bills receivable book, cash-book, goods out ward book, sales returns book etc.
- Where self-balancing system is in use, the total of the balance as per the schedule of debtors should be verified with the total of the balance shown in the debtors ledger adjustment account.
- He should test check postings to this ledger from various books of first entry. He should give special attention to credit postings, as any attempt to conceal defalcations will more usually take the form of factious credit entries
- He should also check the castings and balances with the list of debtors. If there is any credit balance in the sales ledger, he should see that it is shown on the liabilities side of the balance sheet along with sundry creditors.
- While examining the accounts the auditor should ascertain the composition of each balance. In particular he should note whether it represents specific items of goods or is an accumulated balance. In the latter case, he should ensure that it does not represent doubtful for bad debt.
- He should call for a list of bad and doubtful debts and verify them thoroughly ast here is quite possibility of the figure being understated and misappropriated.

VOUCHING OF IMPERSONAL LEDGER:

- It is an important part of the auditor's, duty to vouch the impersonal ledger which contains accounts from which trading and profit and loss accounts and the balance sheet are prepared. The impersonal ledger has two kinds of accounts -Nominal accounts & real accounts. Nominal accounts relate to the trading, profit account and real accounts record assets. Here, the transactions appearing in the impersonal ledger but relating to profit & loss account and the auditor's duty in connection with only those items is to be considered. Whole vouching these transactions, the auditor should consider the following points .
- He should check the totals of the various books of original entry with the accounts in the impersonal ledger.
- He should vouch the Journal carefully and should see that each entry is supported by sufficient evidence. He should also check their postings to impersonal ledger.
- He should test the postings from the cash book to the impersonal ledger in order to ensure that the entries have been posted to the correct accounts.
- In those cases where direct entries are passed from one account to another in the impersonal ledger, he must proceed in the same manner as if they had been passed though the journal. Such items are as follows: