B.com 3rd Semester **Date of the examination: 03rd Dec.2013**

Model Answer: Principles of Auditing [Paper Code: AS 2622]

Note: The answers should be written with adequate content/subject matter, in meaningful language. The examinee is required to make the optimal utilization of the time available.

Section A

Q.1 Short Answer type question:

1. What do you mean by an Auditing?

Ans: Auditing is a systematic and independent examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. In addition the auditor also expresses his opinion on the character of the statement of accounts prepared from the accounting records so examined whether they present a true and fair view.

2. What is Interim Audit?

Ans: It is an audit conducted in the middle of the accounting year before the accounts are closed. In other words any audit conducted between two financial audit is known as interim audit. The objective is to get periodical results, to declare interim dividend.

3. Write two advantages of Audit Programme.

Ans.1.It provides the audit staff clear instructions about their duties. It clarifies as to which work is to be performed by whom and within what time period.

2. It promotes division of work in a well organized manner. Auditor can divide the whole work of audit among his staff on the basis of competence, ability and experience of his staff.

4. What are the essentials characteristics of good Working Paper?

Ans. a) Complete in all respect.

b) Properly organized and arranged.

c) Accurate information.

d) Relevant details should also be kept.

5. What are the objects of Internal Check?

1. Eliminates frauds and errors to prevent misappropriation of goods in cash.
2. To encourage specialization of labor.
3. To reduce the time spent on a particular work.
4. To exercise moral pressure over staff members.
5. To make accounting system more reliable.

6. Mention two main differences between Vouching & Verification.

Ans.

Vouching	Verification
. Vouching examines the entries relating to transactions recorded in books of accounts.	. Verification examines the assets and liabilities appearing in the Balance Sheet.
. Vouching is done throughout the year.	. It takes place at the end of the year.

. It does not include Valuation.	3.It includes valuation.
4.Vouching is normally done by audit assistant.	4.It is done by the auditor himself.

7. What is Special Audit of a Company?

Ans. As per section 233 A of the companies act, the central government has the power to direct special audit in the following cases for a specified period. That is, when the central government is of the opinion.

1. That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices or
2. That any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains or
3. That the financial position of any company is such as to endanger its solvency.

8. Multiple choice questions:

a. Statutory Audit is:

i) Compulsory

ii) Voluntary

iii) Periodical

iv) None of these

b.)An auditor is :

i) As a watch Dog

ii) As a Lion

iii) As a Blood Hound

iv) As a Street Dog

Ans. **a**. Compulsory.

b. As a watch dog.

9. Who are the Persons disqualified for appointment of Company Auditor?

Ans. According to section 226(3) of the Companies Act, the following persons shall not be appointed as auditors of a company.

1. A body corporate.
2. An officer or an employee of the company.
3. A person who is a partner in the business.
4. A person who is indebted to the company for an amount exceeding more than Rs.1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000/-.

If an auditor, after his appointment becomes a subject of any of the above mentioned disqualifications, he shall be deemed to have vacated his office forthwith.

10. What is Test Checking?

Ans. Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but through a process of sampling, selects a few item and if they are found correct, he presumes that the remaining entries would also be correct likewise. Thus, test checking is based on a simple theme that if a representative number of transaction so selected at random by the auditor for test checking is found to be correct ,the remaining ones would also be correct.

Q.2 Long Answer type Question:

1. Define Auditing. Discuss its nature & scope.

Ans. **Spicer and Peglar** define auditing as "An examination of the books, accounts and vouchers of a business's shall enable the auditor to satisfy himself whether or not the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the business according to his best of the information given to him and as shown by the book.

The international auditing practices committee defines auditing as "the independent examination of financial information of any entity whether profit oriented or not and irrespective of size/legal form when such an examination is conducted with a view to express an opinion thereon".

The **scope of audit** is increasing with the increase in the complexities of the busines. It is said that long range objectives of an audit should be to serve as a guide to the management future decisions.

Today most of the economic activities are largely conducted through public finance. The auditor has to see whether these larger funds are properly used. The scope of audit encompasses verification of accounts with a intention of giving opinion on its reliability. Hence it covers cost audit, management audit, social audit etc. It should be remembered that an auditor just expressed his opinion on the authenticity of the account. He has no power to take action against anybody, in this regard its said that "an auditor is a watch dog but not a blood hound".

The scope of audit is clear from the following duties of an auditor:

i. Checking the arithmetical accuracy of the accounts,
ii. Checking the books of accounts with the help of all relevant vouchers, invoices, correspondence, minute books,etc.
iii. Verifying the assets and liabilities shown in the Balance Sheet, and
iv. Reporting to the client on the basis of its findings.

Nature of Auditing:

Auditing is a systematic and independent examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. In addition the auditor also expresses his opinion on the character of the statement of accounts prepared from the accounting records so examined whether they present a true and fair view. Auditing primarily requires judgment at different stages, for which an auditor has to be a man of logic with an independent frame of mind.

Primary steps involved in auditing are determination of an audit programme, examination and collection of evidence, evaluation of evidence for drawing conclusion and reporting on the conclusion reached. The auditor may have to physically verify some assets like cash, investment etc. Audit primarily requires judgment at each stage.

2. Explain in brief different classes of Audit.

Ans. Audit may be classified into two categories,mainly:

1. According to organizational structure of a business;and

i. **Statutory Audit:** any audit carried on as per the requirement of law is called as a statutory audit. eg: all companies have to get their accounts audited as per the provision of the company's Act of 1956.Company Audit, Audit of trust are examples of such audit.

ii. **Private Audit:** The institution which are private in character also get their accounts audited by some qualified auditors.

Such audit is not compulsory by law. Hence it is known as Private Audit. Eg. Audit of accounts of Sole Trader,Partnership firm etc.

iii. **<u>Government Audit:</u>** the audit of different govt. companies is known as govt. audit. Govt. audit is headed by the Comptroller and Auditor General of India.

iv. **<u>Internal Audit</u>:** Internal Audit is conducted by the employees of the business itself. It serves primarily the needs of the management. It is aimed at improving and complying with the established policies and procedure.

2. From practical point of view.

i. **<u>Continuous audit</u>:** a continuous audit is one in which the auditor visits his clients office at regular intervals through out the year to verify the account. The objective of CA may be-

a) To get final account audited immediately after the closure of accounting year.
b) When the business is very large.
c) When interval control system is into effective.
d) When regular final accounts are required.

ii. **<u>Periodical/ Annual Audit</u>:** it is a kind of audit where the auditor verifies the account at the end of the financial year. He starts the audit work after the closure of financial year. This is a common audit and is mostly used by small organizations.

iii. **<u>Interim audit</u>:** its an audit conducted in the middle of the accounting year before the accounts are closed. In other words any audit conducted between two financial audit is known s interim audit. The objective is to get periodical results, to declare interim dividend.

iv. **<u>Balance sheet audit:</u>** it's a kind of partial audit and is concerned with the verification of only those items appearing in the Balance Sheet. It is more popular in the USA. Infact while verifying BS items the auditor verifies/ checks all related items/accounts.

v. **<u>Cost audit</u>:** cost audit is defined as the verification of cost accounting records. Data and techniques for its accuracy and authenticity. It gets as effective managerial tool for the detection of errors and frauds in cost accounting records. The companies act implies the central government to order cost audit incase of specifies companies.

vi. **<u>Management audit</u>:** Management audit may be defined as a comprehensive examination of an organizational structure of a company, institution/government and its plans and objectives it means of operations and use of human and physical facilities. The main objective of mgt audit is to see how far the objectives of mgt are fulfilled. It aims to ascertain whether sound mgt prevails throughout the organisation and evaluates its efficiency in the system of its operation.

vii. **<u>Complete &Partial Audit</u>:** when an auditor is asked to audit only a part of the account system. Its called partial audit. <u>Eg</u>: he may be asked to audit only the payment side of cash book.

viii. **<u>Propriety Audit:</u>** It is that kind of audit wherein the various actions and decisions of the management of an enterprise are examined in the light of public interest and standard of conduct.

ix. **<u>Environmental Audit:</u>** It is aimed at maintaining proper standards for controlling pollution for handling hazardous wastes in factories and reporting to the shareholders and proprietors of the business.

3. What is Audit Note Book? Discuss its merits & demerits.

Ans: An audit note book is one of the most important document maintained by the auditor. It is defined as a record used mainly in recording audit, containing data on work done and comments made. Audit Note book contains information regarding the day to day work performed by the audit staff, notes about errors, explanations required etc. the auditor can use it as an authentic evidence in the court if there is any case against him.

<u>Merits:</u>

1. Proof in the court of law.
2. Knowledge about the progress of audit work.
3. It Helps in Future Planning of audit work.
4. Helpful in preparing Audit Programme.
5. It Records Helpful Matters.
6. Improves quality of audit work.

<u>Demerits:</u>

1. Helpless in defending Auditors.
2. Audit Staff's negligence may be concealed.
3. Lack of Secrecy.
4. Audit work with Suspicion.

- **Students are expected to explain in detail each merit and demerit**.

4. What is Internal Control? Differentiate between Internal Control & Internal Check.

Ans. Internal control is a broad term which is normally used to control financial and non-financial activities. It involves a number of checks and controls exercised in a business to ensure efficient and economic working.

Internal Control is defined as “the whole system of controls, financial and otherwise established by the management in the conduct of a business including internal check, internal audit and other forms of control.

Various forms of internal control help in ensuring correct and reliable records of transactions and Operational efficiencies.

Accounting control

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing.

Administrative control

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organization that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. Time and motion studies, quality control through inspection,statistical analysis and performance evaluation etc.

Point	Internal check	Internal control
1. Meaning	It is a system of allocation of responsibility, division of work and methods of recording transactions, whereby the work of one employee is checked continuously by another.	It is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records.
2. Relation	It is a part of Internal Control.	It includes Internal check and Internal audit.
3. Essence	It is arrangement of book-keeping and Clerical duties.	It includes the essence of Internal check and internal audit.
4.How are they implemented.	Checks are automatic and continuous.	It includes the implementation of Internal check and Internal audit.
5.Cost involved	Relatively it is cheaper.	Relatively setting up of internal control system is costly and time consuming
6.Applicability.	It is applicable to both, small & large organizations.	Generally it is more applicable to large organizations where there are many departments.

5. What do you understand by Vouching? Discuss the objects of Vouching.

Ans. Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy. When the auditor checks the entries with some documents it is called vouching.

Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It is an act of examining documentary evidence in order to ascertain the accuracy and authenticity of the entries in the books of accounts

According to **Dicksee** "Vouching consists of comparing entries in the books of accounts with documentary evidence In support thereof."

The basic objectives of vouching are as under:

1 To ensure that all the transactions are properly recorded in the books of accounts.

2.To see the proper evidence supports all the entries of the transactions.

3 To make it sure that fraudulent transactions are not recorded in the books of accounts.

4 To see that all transactions relating to business are recorded in the books of accounts.

5.To see that all transactions are properly authenticated by a responsible person.

- **Students are expected to explain all its objective in detail.**

6. What is meant by Verification in Audit? How would you verify Current Assets & Investment?

Ans. Verification is a process carried out to confirm the ownership valuation and existence of items at the balance sheet date.

Spicer and Pegler define verification as, "the verification of assets implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets.

It is also defined as a process by which the auditor substantiate the accuracy of the right hand side of Balance Sheet and must be considered as having 3 distinct objects, i.e., verification of the existence of assets, the valuation of assets and authority of their acquisition.

The auditor is required to report whether the Balance Sheet exhibits the true and fair view of the business. For this, he has to examine and ascertain the correctness of money value of assets and liabilities as shown in the Balance Sheet.

<u>C. Current Assets.</u>

Current Assets are those assets which are easily converted into cash within a period of 1 year during the normal course

of business. Some of the current assets are as follows:

1. **Stock/ Inventories:** Stock is the life blood of the business. It consists of stores and spares, raw materials, work in progress, and finished goods. If stock is incorrectly recorded, verified or valued, the P&L a/c doesn't show correct balances. It also affects the BS if stock if overvalued profit is inflated and if its understated it encourages creation of secret reserves.

The objective of verifying stock is to see that it exists and is correctly valued. It may not be possible to verify the entire stock. Hence he has to go for the checks to ascertain the accuracy of stock.

While verifying stock:

a. He should review the procedure for maintenance of stock and records.

b. Examine the efficiency of internal check and control system.

c. See whether stock verification process contains adequate safeguards against possible errors and frauds.

d. Test check the physical existence of a part of the stock. Stock is valued at cost price/ market price whichever is lower/less.

2. **Bills Receivable:** B/R is the acceptances given by Debtors. The objectives of verifying bills receivable are:

i. To establish the accuracy of amounts.

ii. To know the validity of the bills.

iii. To know whether they are reliable and to see whether there is a fair disclosure in the BS.

While verifying the BS the auditor

a. should examine bills receivable book.

b. to see whether any bill is honored after the BS is prepared but before auditing for this he should vouch the cash book.

c. I bills are discounted; he should vouch the cash book and should see whether it is shown as a contingent liability in the BS with proper provision.

d. He should see that bills receivable dishonored and not renewed are not shown in the bills receivable book.

3. **Book Debts/ Sundry Debtors:** Book debts are to be classifies as good, bad and doubtful. The auditor should see the accuracy, validity, and collectability and confirmation letters directly from the debtors. For any balance for which no confirmation is received, he should carefully verify the account. He should see that proper provision is made for bad debts. Failing to do so the auditor will be held guilty for negligence.

Investment: It may consist of govt., bonds, shares, securities etc. The auditor should examine whether the company is authorized to make investments. He should see whether the legal formalities have been completed. If the investments are larger in number he should obtain the schedule of investments certified by a responsible official. The statement should include name of the investment date of purchase, book value, market price, rate and date of interest, tax deducted etc. It is advisable to verify all investment at a time.The list of investment should be tallied with the investment account. He should examine the authority and related procedure for making purchase of such investment..Investment with fixed nature should be shown at cost price and current investment at cost price or market price, whichever is lower.

7. What are the provisions of law regarding the appointment & removal of company auditor?

Ans. According to Section 224 of the Companies Act, every company whether private or public must appoint an Auditor

or auditors to audit the final accounts. The provisions relating to the appointment of auditor are as follows:

1) **Board of Directors:**

The first auditor of a newly floated company is appointed by the board of directors, within one month of registration of the company. Such an auditor or auditors shall hold office till the conclusion of the first annual general meeting.

The directors are also empowered to fill a casual vacancy of an auditor if it is not caused by resignation. The auditor so appointed shall hold office till the conclusion of the next annual general meeting. But in case, if the vacancy is caused by the resignation of an auditor, it shall only be filled by the company in its annual general meeting.

2) **Annual General Meeting:**

The auditor or auditors are appointed in the annual general meeting under the following circumstances:

1) If the board of directors fail to appoint an auditor, the shareholders shall make an appointment in the annual general meeting.

2) Every company shall at each annual general meeting appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3) The company has to give intimation to the auditor so appointed within seven days of his appointment.

4) The auditor so appointed shall within 30days of the receipt of intimation from the company regarding his appointment, has to inform the registrar of the company in writing whether he has accepted or refused the appointment.

In every annual general meeting the appointment of the company's auditor is made **by the simple majority of votes** by the present members.

Appointment of Auditor by Special Resolution.

In 1974, Companies Act 1974 was amended by adding sub section A to section 224. After that, in some cases, the appointment of auditors or auditor requires special resolution. That is in case of a company, in which not less than 25% of the subscribed share capital is singly or jointly held by.

a. A public financial institution or a government company or the central government or any state government or

b. Any financial or other institution established by any provincial or state Act in which a state government holds not less than 51% of the subscribed share capital or

c. A nationalized bank or an insurance company carrying on general insurance business.

3) Central Government:

According to section 224 (3), if the auditor has not been appointed in the annual general meeting, the company has to inform within seven days to the Central Government to appoint an auditor. As per section 233 A of the companies act, the central government has the power to direct special audit in the special circumstances for a specified period.

Removal of an Auditor.

1. The first auditors appointed by the directors prior to the first annual general meeting of the company may be removed by the members in the annual general meeting even if there tenure of office has not expired.
   The general meeting may in their place, appoint any other person, notice for whose nomination has been given by any member not less than 14days before the date of the meeting.
2. In any other case, the auditor may be removed from office before the expiry of his term by the company in the annual general meeting after obtaining the previous approval of the central government in this behalf. This provision is as per section 224(7) of the Companies Act.
3. But section 225 of the Companies Act makes special provisions in this respect, in order to safeguard the interests of an independent auditor against unfair and unjust removal at the hands of an unscrupulous management.

The procedure so laid down is as follows:

a. Special notice of intention to make such resolutions to remove the existing auditor must be given to the company by the shareholder not less than 14days before the annual general meeting.
b. On receipt of such a notice, the company must forthwith send a copy to the retiring auditor.
c. The retiring auditor has the right to send a representation to the company which he can ask the company to send to the shareholders.
d. If a copy of the representation is not sent to the members, either because it was received too late to be thus sent, or because of the default of the company, the auditor may insist that the representation shall be read out in the meeting.
e. The auditor, who is proposed to be removed, has the right to attend the general meeting where his removal is to be discussed. He also has the right to speak at such a meeting.
f. As a matter of professional conduct, the auditor so appointed in place o another should communicate with the retiring auditor in writing before accepting the appointment. If he does not do that, he may be held liable for disciplinary action as per the regulations of the Institute of Chartered Accountants of India.

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