AUDITING

B.COM. 6th Semester (SW)

UNIT- I

AN OVERVIEW OF AUDITING

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors. If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the barfly makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money. As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions 3 As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits. A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

EVOLUTION OF AUDITING

The term audit is derived from the Latin term ‘audire,’ which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances. The original objective of auditing was to detect and prevent errors and frauds Auditing evolved and grew rapidly after the industrial revolution in the 18th century With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees. The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds. In India the companies Act 1913 made audit of company accounts compulsory. With the increase in the size of the companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts The companies Act.1913 also prescribed for the first time the qualification of auditors The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the accountants and auditors in the day to day work The later developments in auditing pertain to the use of computers in accounting and auditing. In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

DEFINITION AND MEANING OF AUDITING

The term auditing has been defined by different authorities. 1. Spicer and Pegler: "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied." Prof. L.R.Dicksee. "Auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate. 3 The book "an introduction to Indian Government accounts and audit" "issued by the Comptroller and Auditor General of India, defines audit “an instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor."

FEATURES OF AUDITING

a. Audit is a systematic and scientific examination of the books of accounts of a business;

b. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.

c. Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

d. Audit is a critical review of the system of accounting and internal control.

e. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

f. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

g. The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of shareholders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

OBJECTIVES OF AUDITING

There are two main objectives of auditing. The primary objective and the secondary or incidental objective.

a. Primary objective – as per Section 227 of the Companies Act 1956, the primary duty (objective) of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company’s state of affairs and the profit and loss account gives a correct figure of profit of loss for the financial year.

b. Secondary objective – it is also called the incidental objective as it is incidental to the satisfaction of the main objective.

The incidental objective of auditing are:

i. Detection and prevention of Frauds, and

ii. Detection and prevention of Errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view.

As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated. Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. Clerical errors.

IMPORTANCE OF AUDITING

Importance of auditing can be judged from the fact that even those organizations which are not covered by companies Act get their financial statements audited. It has become a necessity for every commercial and even non- commercial organization. The importance of auditing can be summed in following points:

a. Audited accounts help a sole trader in knowing the value of the business for the purpose of sale.

b. Dispute over correctness of profits can be avoided.

c. Shareholders, who do not know about day-to-day administration of the company, can judge the performance of management from audited accounts.

d. It helps management in detecting and preventing errors and frauds.

e. Management gets advice on financial affairs from the auditors.

f. Long and short term creditors depend on audited financial statements while taking decision to grant credit to business houses.

g. Taxation authorities depend on audited statements in assessing the income tax, sales tax and wealth tax liability of the business.

h. Audited accounts are useful for the government while granting subsidies etc.

i. It can be used by insurance companies to settle the claims arising on account of loss by fire.

j. Audited accounts serve as a basis for calculating purchase consideration in case of amalgamation and absorption.

k. It safe guards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

TYPES OF AUDIT

Based on ownership: On the basis of ownership audit can be:-

1. Audit of Proprietorship: In case of proprietary concerns, the owner himself takes the decision to get the accounts audited. Sole trader will decide about the scope of audit and appointment of auditor. The auditing work will depend upon the agreement of audit and the specific instructions given by the proprietor.

2. Audit of Partnership: To avoid any misunderstanding and doubt, partnership audits their accounts. Partnership deed on mutual agreement between the partners may provide for audit of financial statements. Auditor is appointed by the mutual consent of all the partners. Rights, duties and liabilities of auditor are defined in the mutual agreement and can be modified by the partners.

3. Audit of Companies: Under companies Act, audit of accounts of companies in India is compulsory. Chartered accountant who is professionally qualified is required for the audit of accounts of companies. Companies Act 1913 for the first time made it compulsory for joint stock companies to get their accounts audited from a qualified accountant. A number of amendments have been made in companies Act, 1956 and 2013 regarding appointment, duties, qualification, power and liabilities of a qualified auditor.

4. Audit of Trusts: The beneficiaries of the trusts may not have access and knowledge of accounts of the trust. The trustees are appointed to manage and look after the property and business of the trust. Accounts of the trust are maintained as per the conditions and terms of the trust deed. The income of the trust is distributed to the beneficiaries. There are more chances of frauds and mis-appropriation of incomes. In the trust deed as well as in the Public Trust Act which provide for compulsory audit of the accounts of the trust by a qualified auditor. The audited accounts of the trust ensure true and fair view of accounts of the trust.

5. Audit of Accounts of Co-operative Societies: Co-Operative societies are established under the Co-Operative Societies Act, 1912. It contains various provisions for the regulations and the working of these societies. Some of the states have adopted it without any change, while others have brought certain changes to it. The auditor of the Co-operative Society should have an expert knowledge of the particular act under which Co-operative society under audit is functioning. He should also study by-laws of the society and make sure that the amendments made from time to time in the by-laws have been duly registered in the Registrar’s Office. Companies Act is not applicable to the co-operative Societies. The Registrar of co-operative societies shall audit or cause to be audited by some person authorized by him, the accounts of the society once in every financial year.

6. Government Audit: Audit of government offices and departments is covered under this heading. A separate department is maintained by government of India known as Accounts and Audit Department. This department is headed by the Comptroller and Auditor General of India. This department works only for the government offices and departments. This department cannot undertake audit of non-government concerns. Its working is strictly according to government rules and regulations.

Based on Time: On the basis of time the audit can be of following types:

INTERIM AUDIT: An audit that is taken up between two annual audits is called an Interim Audit. A specific date, as per the client's requirement is taken into account, e.g. 30th September, 31st December, etc. a trial balance is drawn and verified with a view to prepare financial statement. Financial statement are prepared and authenticated for the interim audit period. Assets and liabilities are verified for interim 39 balance sheet purposes. Independence is considered less independent than the statutory Auditor; generally an employee of the enterprise will be the internal auditor. In the interim audit no format is prescribed. It depends on the nature of work, coverage and audit observations.

CONTINUOUS AUDIT: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period. A continuous audit is preferred for the following reasons: i. It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors of frauds uncovered by such an audit. ii. The frequent attendance by the staff deters persons so inclined, from committing a fraud. iii. The accounting staff of the client is motivated to keep the books of account up-to-day.

"A continuous audit involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole period of trading." - T.R. Batliboi
"A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or hiss staff attends at regular or irregular intervals during the period." -R.C Williams

Advantages of continuous Audit:

a. Complete checking of all the records: Since the audit is carried out throughout the year, sufficient time is available for detailed checking. Any enquiry and doubt arising in the course of audit can be tackled in a better way.

b. Proper planning: Auditor can plan his audit work in a systematic manner. He can evenly spread his work throughout the year. It will improve efficiency of auditor.

c. Early detection of frauds and errors: The work of auditor becomes easier for detecting frauds and errors, otherwise it will involve more time.

d. Up-to-date accounts: The efficiency of account staff will increase and their work will be up-to-date and accurate.

e. Valuable suggestions: Continuous audit will help the auditor to understand the technicalities of business. This will help the auditor to make suggestions for the improvement of business.

f. Preparation of interim accounts: Interim accounts can be prepared without much delay. It will help the Board of Directors to declare interim dividend.

Disadvantages of Continuous Audit:

a. Expensive: It is an expensive system as it may not suit the budget of small organizations.

b. Dislocation of routine work: Frequent visits by auditor may dislocate the smooth flow of office work.

c. Alteration of Figures: after the accounts have been audited, the figures may be fraudulently altered by the staff.

d. Losing link in the audit work: As the work is not completed continuously, the auditor may lose continuity and certain questions and inquires may be left unanswered.

3. Final Audit: Final Audit means when the audit work is conducted after the close of financial year. A final audit is commonly understood to be an audit which is not commenced until after end of the financial period and is then carried on until completed.

4. Balance Sheet Audit: Balance Sheet Audit relates to the verification of various items of balance sheet such as assets, liabilities, reserves and surplus, provisions and profit and loss balance. The procedure under this audit is to follow a backward process. First the item is located in balance sheet, and then it is located in original record for the purpose of verification.

Based on Objectives: On the basis of objectives the audit can be of following types:

1. Internal Audit: It implies the audit of accounts by the staff of the business. Internal audit is an appraisal activity within an organization for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of operating nature.

2. Cost Audit: Cost Audit is the verification of the correctness of cost accounts and adherence to the cost accounting plans. Cost Audit is the detailed checking of costing system, techniques and accounts to verifying correctness and to ensure adherence to the objectives of cost accounting.

3. Secretarial Audit: Secretarial Audit is concerned with verification compliance by the company of various provisions o Companies Act and other relevant laws. Secretarial audit report includes

a. Whether the books are maintained as per companies act, 2013.

b. Whether necessary approvals as required from central Government, Company law board or other authorities were obtained.

4. Independent Audit: Is conducted by the independent qualified auditor. The purpose of independent audit is to see whether financial statements give true and fair view of financial position and profits. Mainly it is for safeguarding the interest of owners, shareholders and other parties who do not have knowledge of day-to-day operations of organization.

5. Tax Audit: Now-a-days tax audit has become very important to ascertain the accuracy of tax related documents. Tax audit mostly covers income returns, invoices, debit and credit notes and various current and fixed assets. Tax audit is an innovation of 21st century. It has added one more chapter to the practice of auditing. Tax audit ensures the validity and credibility of tax related documents.

SUM UP

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period. The term auditing has been distinguished from accounting and investigation. The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation. Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like. Objectives of audit are broadly classified into a) primary objective and b) secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds. A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc. Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit. Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

KEYWORDS

Auditing: Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period. Continuous audit: An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

Errors: Mistakes committed innocently and unknowingly while making entries in the books of accounts. Frauds: Fictitious entries made in the books of accounts with certain motives. Interim audit: An audit which is conducted for a part of the accounting period for some specific purpose. Investigation: Examination of accounts for special purpose. Qualified auditor: A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act,1949. Statutory audit: An audit undertaken under any specific statute or Act. True and fair view: A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain errors and fraud.

BASIC PRINCIPLES OF AUDIT

AAS-1 describes the basic principles, which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. These are:-

1. Integrity, objectivity and independence: The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever it's actual effect, as being incompatible with integrity and objectivity.

2. Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is legal or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.

3. Skill and competence: The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others: When the auditor delegates work to assistant* or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise & review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.

5. Documentation: The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.

7. Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.

8. Accounting system & internal control: The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

9. Audit conclusions and reporting: The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.

UNIT- II

QUALIFICATION OF AN AUDITOR

The provision regarding qualification of auditor is governed by Section 226 of the Companies Act, 1956 Sec 226(1) states

• A person will be qualified for appointment as an auditor of a company (public or private) only if he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949

• The same section also provides that a firm of Chartered Accountants will be qualified for appointment as the auditor of a company in its firm name provided all the partners practicing in India are qualified for appointment

• In case of the firm being appointed as auditor, any practicing partner may act in the name of the firm.

DISQUALIFICATION OF AUDITORS

The provision regarding disqualification of auditor is governed by section 226 of the Companies Act, 1956.

1. Section 226(3) The following persons are not qualified for appointment as auditors of a company:

a) A body corporate an officer or employee of the company 219

b) A partner or employee of an officer or employee of the company

c) A partner or employee of an officer or employee of the company

d) A person who is indebted to the company for more than Rs. 1000 OR A person who has given any guarantee or provided any security in connection with the Indebtedness of any third person to the company for more than Rs. 1000.

e) A person holding any security (a security would mean an instrument carrying voting rights) of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

2. Section 226(4) A person is not eligible for appointment as an auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company and vice- versa.

3. Section 226(5) If an auditor after his appointment, becomes subject to any of the disqualification mentioned in section 226(3) and section 226(4), he shall be deemed to have automatically vacated his office.

APPOINTMENT OF FIRST AUDITORS

The main points regarding appointment of the First Auditors of a company are given in Section 224(5):

1. The first auditors of a company can be appointed by the board of directors within one month of the date of registration/ incorporation of the company by means of a resolution.

2. The auditors so appointed shall hold office until the conclusion of the first Annual General Meeting.

3. If the Board of Directors fails to appoint the First Auditor within one month, the company in a general meeting is empowered to make the appointment.

4. The auditors so appointed by the Board of Directors may be removed by the company at a general meeting which may appoint any other auditor.

5. An auditor cannot be appointed as First Auditor simply because his name has been stated in the Articles of Association.

6. The First Auditor need not sent an intimation by the company of their appointment and the First Auditor are themselves not required to inform the registrar of Companies about their acceptance/ refusal of such an appointment.

APPOINTMENT OF THE SUBSEQUENT AUDITOR/REAPPOINTMENT

The main points regarding appointment of Subsequent Auditor of a company are given below:-

1. Section 224(1) empowers the shareholders to appoint auditor at each Annual General Meeting by means of a resolution.

2. Upon an auditor being appointed in the Annual General Meeting, the company is to give intimation thereof to the concerned auditor within seven days of the appointment.

3. On receipt of the intimation from the company about his appointment, the auditor is required to send a written communication to the concerned Registrar of Companies within 30 days in form no.23B indicating whether he has accepted or declined the appointment.

4. The auditor so appointed shall hold the office from the conclusion of one Annual General Meeting to the conclusion of the next Annual General Meeting.

5. The auditor will be guilty of professional misconduct if at any time he accepts audit more than the specified numbers of audit assignments of the company u/s 224 of the Act.

REMOVAL OF AUDITOR

1. The first auditor appointed by the directors may be removed by the shareholder in the first Annual General Meeting. Such Auditors can even be removed from their office before the expiry of their term of office without the permission from the Central Government.

2. In any other case, auditor can be removed only by the company in General Meeting after obtaining previous approval from the Central Government

3. An Auditor, on the expiry of the terms of his office may not be reappointed and thus removed from his office.

a) Resolution requiring special notice (of fourteen days) should be passed at the general meeting [Sec. 225(1)].

b) On receipt of notice of resolution, company shall send copy of the notice to the retiring auditor [Sec. 225(2)].

c) On receipt of notice, retiring auditor can send written representation of a reasonable nature to the company which should be informed to the members. Normally company has to circulate such representation to the shareholders, unless it is received too late. A notice of resolution also should be circulated, stating a fact of such a representation. If the representation in not circulated for being received too late or because of the default of the company, auditor can insist it to be read at the meeting. [Sec. 225(3)].

d) However, company or any other person like directors or shareholders have a right to file a petition with Company Law 221 Board (CLB) to refrain the e) auditor from making such representation, if it is to secure needless publicity or is defamatory. In such a case, on the direction of the CLB, copies need not be sent or read at the meeting [Sec. 225(3)]. These provisions apply to removal of the auditors appointed by Central Government also.

4. The other relevant provisions are that if a new auditor is appointed, the company should within 7 days, inform the new auditor. The new auditor should inform the Registrar within one month of such intimation received about his decision and he should also communication with the retiring auditor in this matter, is he accepts the post.

QUALITIES OF AN AUDITOR

Auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.

In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles. He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact.

The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable. He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. AAS-8 on 'Audit Planning' emphasises that an auditor should have adequate knowledge of the client's business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

REMUNERATION OF AN AUDITOR (SEC 142)

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

2. 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

1. 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.

2. 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):

a. 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.

b. 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.

c. 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

The liabilities of an auditor can be summed under following heads:

1. Civil liabilities
2. Criminal Liabilities

1. 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.

2. Criminal Liabilities:

i) 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.

ii) 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.

iii) 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

iv) 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 for a term not less than 3 years extendable to 5 years and with fine not less than 1 lakh extendable to three lakhs.

V) 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-III

MEANING OF AUDIT PROGRAMME

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statement of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit programme is a detailed of the accounting records of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to be rendered by the auditor are the other factors that vary from assignment to assignment. Because of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However it becomes a necessity to specify in details in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of. An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to 47 express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

1. stay within the scope and limitation of the assignment.

2. determining the evidence reasonable available and identify the best evidence for deriving the necessary satisfaction.

3. Apply only these steps and procedures which are useful in accomplishing the verification purpose In the specific situation.

4. consider all possibilities of error.

5. co-ordinate the procedures to be applied to related items. Amplification is not necessary of the above points except the one under evidence: that is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of experts knowledge and evidence. This is the primary taks before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonable available in respect of each transaction.

ADVANTAGES OF AUDIT PROGRAMME

a. It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.

b. It is essential, particularly for major audits, to provide a total perspective of the work to be performed.

c. Selection of assistants for the jobs on the basis of compatibility becomes easier when the work is rationally planned, defined and segregated.

d. Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.

e. The assistance, by putting their signature on programme, accepts the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.

f. The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.

g. It serves as a guide for audits to be carried out in the succeeding year.

h. A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

DISADVANTAGES OF AUDIT PROGRAMME

a. The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

b. The programme often tends to becomes rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon. c. Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instructions in the matter is contained therein.

d. A hard and fast audit programme may kill the initiative of efficient and enterprising assistants. All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observed matters objectively and bring significant matters to the notice of supervisor/principal.

AUDIT NOTE BOOK

Audit note book is a diary or register maintained by audit staff to note errors, doubtful quarries and difficulties. The purpose is to note down the various points which need to be either clarified with the client or the chief editor. The Audit note book is used for recording important points to be included in **the auditor's report.**

CONTENTS OF AN AUDITOR'S NOTE BOOK

1. A list of books of accounts maintained.
2. The names, duties and responsibilities of principal officers.
3. The particulars of missing receipts and vouchers.
4. Mistakes and errors detected.
5. The points which need clarifications and explanations.
6. The points deserving the attention of the auditor.
7. Various totals and balances.
8. The Points to be a part of auditor's report.

ADVANTAGES OF AUDIT NOTE BOOK

Some of the advantages of the audit note book are.

1. It ensures the uniformity and helps in knowing the amount of work performed.
2. Important matters relating to the audit work may be easily recalled.
3. Facilities and preparation of the audit report.
4. In case of the assistant in charge is changed, no difficulty is faced in continuing the incomplete work.
5. The responsibility of the errors undetected can be fixed on clerk concerned.
6. The audit note book shows the extent of the interest and pain taken by the audit staff. It helps in their appraisal.
7. It ensures that the audit programme has been sincerely followed. Deviations can be noticed.
8. It is reliable evidence in the court of law, If an auditor has to defend himself.

INTERNAL CONTROL

Meaning and Definition

Internal control is a broad term with a wide coverage. It covers the control of whole management system. Internal control involves a number of checks and controls exercised in a business to ensure its efficient and economic working.

According to The American Institute of Certified Public Accountants, "Internal control comprises of the plan of organization and all the coordinate 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."

The system of internal control can be defined as, "the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving the management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business."

In brief it can be stated that internal control includes not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, to safeguard its assets and to secure as far as possible the accuracy and reliability of records.

OBJECTIVES/NEED OF THE INTERNAL CONTROL

1. Providing reliable data: Business decisions require accurate information o run the business efficiently. Examples of significant areas where management requires reliable information are fixation of selling prices production directives depending upon requirements etc. with the efficient internal control in place the accurate, required and reliable information can be provided for taking the important decisions and efficient performance of the activities.

2. To promote operational Efficiency: the controls within an organization are meant to prevent unnecessary duplication of efforts, protect against waste in all aspects of business and discourage other types of inefficient use of resources so as to promote the operational efficiency.

3. To encourage adherence to the prescribed policies: the system of internal control is meant to provide reasonable assurance that procedures and rules of various institutes are followed by company personnel.

4. Safeguarding assets and records: the physical assets of the company can be stolen, misused or accidently destroyed if not properly protected by adequate controls. The internal control helps to safeguard the physical assets and to secure the accuracy and reliabilities of the records of the company.

INTERNAL CHECK

Internal check is the valuable part of the internal control. It is an arrangement of the duties of members of staff in such a manner that the work performed one person is automatically and independently checked by the other.

According to F.R. M.e paula, “internal check means practically a continuous internal audit Carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff.”

According to D.R. Davar, “ Internal check is a system or method introduced with defined instructions given to staff as to their sphere of work with a view to control and the verification of their work and also the maintenance of accurate records as the ultimate aim.

According To Joseph Lancaster, “The internal check is a method of organizing the entire operations, office, warehouse, factory and the duties to the respective staff so that frauds and irregularities are impossible without collusion.” 16

All the definitions of internal check give a common idea about system organized within the concern itself, wherein the work of one employee is automatically checked up by the other and the possibility of error or fraud is reduced to the minimum.

OBJECTIVES OF INTERNAL CHECK

1. To exercise moral pressure over the staff.

2. To ensure that the accounting system produces reliable and adequate information.

3. To provide protection to the resources of the business against fraud, carelessness and in efficiency.

4. To distribute work in such a manner that no business is left unrecorded.

5. To allocate duties and responsibilities of each clerk in such a way that he may held responsible for particular fraud or error.

6. To increase the efficiency of clerks because the allocation of duties is based on the principle of division of labour.

7. To detect errors and frauds easily if it is committed, because in an efficient internal check system, there is a provision for independent checking.

INTERNAL CHECK WITH REGARD TO SALES

The system of internal check regarding sales should take care of following:

1. On receipt of the order, it should numbered and preserved in Orders Received Book with full particulars.

2. The Despatch Department should be given a copy of the order with necessary particulars.

3. The Despatch Department should take steps to pack the goods as per order.

4. The statement of goods as prepared by the Despatch Department should be checked with the customer's order and then invoice will be prepared in triplicate by means of carbon papers.

5. A responsible official should check the invoice particularly the rates charged and calculations made.

6. With the help of the copy of invoices entries should be made in Sales Day Book.

7. On dispatch of the goods records should be made in the Goods Outward Book.

8. Two copies of the invoice may be sent to customer who will return one of them after signing it. It will serve the purpose of delivery note. Third copy will be retained for further reference.

9. Entries should be made in Goods inward Book for all the goods returned by the customers. Credit notes should be prepared and should be duly checked and initialed by the responsible official.

10. With the help of credit notes, records should be made in the Sales Return Book.

INTERNAL CHECK WITH REGARD TO PURCHASES

1. Requisition: the procedure for issuing purchase requisitions should be specified. The head of the department, who is need of goods, should fill a requisition slip duly signed and then should send to the purchase department. The details about the quality, quantity and the time by which the goods must be supplied be clearly mentioned in the requisition slip.

2. Enquiry: Purchases department makes an enquiry about terms and conditions of the purchases from different suppliers for these purposes tenders are generally invited. But, who shall open and accept the tenders, should be clearly specified. As rule lowest tender should be accepted and decision be taken.

3. Purchase Order: the purchase department places orders which should be recorded in the purchase order book. Four copies of purchase order should be prepared. One copy will be sent to vendor, the second to the store department, third to the accounting department and fourth will be retained by the purchase department itself. A responsible officer should review the purchase order, before signing by the authorized person or director.

4. Receipt of goods: on receipt of goods, the purchase department should properly inspect them, and after an entry in the goods inward (receipt) book, the same should be sent to the stores. Concerned department should be informed about the receipt of goods.

5. Making the payments: the purchase department should thoroughly check the invoices and send the same to accounting department for payment. The accounting department should compare the invoice with the purchase order and incoming inspection report and should verify the calculations. The accounts department should enter the invoice in purchase book. Only responsible official should draw cheque for the payment of invoice. At the time of signing, a signing authority must verify that correct payment is made.

INTERNAL CHECK WITH REGARD TO FIXED ASSETS

1. A proper authority should be designated for the sanction of capital expenditure. The authority may be given to managing director, a factory manager or a committee may be set up for this purpose.

2. A proper authority should be designated even for sale of fixed assets, transfer or even for discarding of an asset.

3. Proper accounting records in respect of fixed assets should be maintained and it should be ensured that the proper accounting distinction is observed between capital and review expenditure.

4. There should be a periodic inspection of assets.

5. A fixed asset register must be maintained giving details of all the fixed assets. In this register description of the assets, their cost and location should be mentioned. Management should also ensure that all the fixed assets are verified physically from time to time.

6. Perfect arrangements should be made to ensure that fixed assets are properly maintained and applied in the service of the company.

7. Where the fixed assets are transferred between branches or members of the sale group, proper arrangements in respect of their pricing, depreciation and accounting should be made.

8. Depreciation rates are to be authorized and evidenced and which persons are to be responsible for carrying out and checking the necessary calculations.

9. Lastly it should be seen that these fixed assets should be adequately insured.

INTERNAL CHECK WITH REGARD TO CASH TRANSACTIONS

CASH RECEIPTS:

1. There should be a separate clerk known as cashier to deal with the receipts of cash. Immediately upon receipts of cash a rough record of the amount should be made. The cashier should not be authorized to keep cash with him. He should not be allowed to make expenditure out of it and to make entries in the ledger an d other books of prime entry.

2. All receipts should be banked daily. From time to time the bank reconciliation statements should be prepared to reconcile bank and cash balances.

3. Bank pay- in-slips should not be prepared by the same person who is incharge of making actual deposits in the bank.

4. All receipts should be acknowledged by means of printed receipts. Counter-foils of all the receipts issued should be properly maintained. Unused receipt must be kept with some responsible officer.

5. Spoiled receipts should be cancelled and not torn off. If some alterations is made in the receipts already written, it should be properly initialed.

6. Copies of receipts previously issued must be marked duplicate.

7. Some responsible persons of the firm should verify the balance of cash by carrying out a surprise physical check from time to time.

CASH PAYMENTS:

1. The person in charge of making payments should have no connection with the receipts of cash.

2. All payments should, as far as possible be by chance cheques excluding petty cash payments. The cheques drawn for payment should be order cheques and as far as practicable they should be crossed.

3. Arrangements should be made to ensure that the vouchers supporting payments cannot be presented for the payments twice, such vouchers should be stamped as paid before the cheques are signed.

4. An official should check up the statements received from creditors and verify with the invoices and ledger accounts only after proper verifications cheques should be drawn in favour of the creditors.

5. For sanctioning the payments of special nature, only directors and senior officers should be empowered.

6. Bank reconciliation statements should be prepared to reconcile bank and cash balances from time to time by some authorities other than the cashier.

7. Bank cheques must be held under lock and key with a responsible officer.

8. Receipts duly signed and stamped should be obtained for each payment.

9. Receipts so obtained should be properly arranged and maintained through proper filing system.

10. To ensure the availability of cash discounts, monthly or periodic payments should be made on the fixed dates.

AUDIT SAMPLING

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the design and selection of an audit sample and the evaluation of the sample results. This AAS applies equally to both statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence

2. When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.

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

4. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount)does not qualify as audit sampling with respect to the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

FACTORS IN DETERMINING SAMPLE SIZE- SAMPLING RISK

(1)When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error.

(2) Sampling risk arises from the possibility that the auditor conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

(3) The auditor is faced with sampling risk in both tests of control and substantive procedure as follow: (a) Tests of control: (I) Risk of under reliance: The risk that, although the sample result dose not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment. (II) Risk of over reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such as an assessment. (b) Substantive procedures: (I) Risk of incorrect rejection: The risk that, although the sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated. (II) Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.

(4) The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

(5) Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable Error 1. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error 2. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures

SELECTION OF THE SAMPLE

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected. While there are a number of selection methods, three methods commonly used are: Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. Systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch. * Haphazard selection, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily 64 located, as they may not be representative

UNIT - IV

INTERNAL CHECK

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself. Spicer and Pegler have defined a system of internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons., fraud is prevented and at the same time possibilities of errors are reduced to a minimum". De Paula has defined internal check as "a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff." Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.

The essential elements of internal check are as under

• Existence of checks on day to day transactions.

• The check is to be carried out continuously as a part of the routine system.

• The work is divided among the staff and each staff is assigned a specific task.

• The work of each staff though independent is complementary to the work of another.

The system of internal check is increasingly recognised by the auditor specially when the size of the concern is large. The existence of effective internal check system relieves the external auditor of detailed checking to a larger extent. The extent to which an external auditor can depend upon the system of internal check is based on the procedural tests applied by him to find out the effectiveness of the system. However the auditor can not be relieved of his responsibility if he was found guilty of negligence regardless of the fact that he had tested the internal check in existence in the organisation before he had accepted it as correct.

OBJECTIVES OF INTERNAL CHECK

• To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.

• To detect fraud and errors easily and correct them promptly.

• To exercise moral pressure among the members of the staff.

• To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.

• To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

• To have an accurate and reliable record of all business transactions. Essentials of good internal check system

• No single staff shall have absolute control over recording of all the aspects of business transactions by himself.

• The same staff shall not be allowed to have access to all books of accounts as well as physical custody of the assets.

• Each member of the staff should be made responsible for a specific work.

• All officials and employees holding responsibility towards cash, securities or stock should be encouraged to proceed on annual leave to prevent the concealed fraud.

• The duties of the members of the staff should be changed from time to time.

• Attempt should be made to introduce mechanical devices to prevent mis-appropriation of cash.

• Each transaction should pass through a definite route and through several hands.

• All books, vouchers, documents should be classified and made available for easy reference.

• Proper record must be maintained of the incoming and outgoing of goods from the business premises.

• Self balancing ledger system should be introduced to make the system more efficient and effective.

• No undue importance should be given to any staff member and too much reliance on any staff member should be avoided.

• Division and allocation of duties among the staff members must provide for an automatic check by others.

MEANING AND DEFINITION OF INTERNAL CONTROL

Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organisation These days business has been become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate. The Internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business. The American Institute of Public Accountants has defined internal control as the plan of organisation and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments. The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records". If we analyze the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves a sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management. Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. Generally, a system of internal control will include all those measures which assist a business enterprises to fulfill the following objectives.

OBJECTIVE OF INTERNAL CONTROL

- To minimize, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.
- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
- To measure how far the policies of the management are being implemented, and
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

INTERNAL AUDIT

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation. The term internal audit has been defined as "an independent appraisal of activity" within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls. According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management." The overall objective of internal auditing, therefore, is to assist the management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. In short internal audit assures the management that the system of internal check and other types of controls are effective in design and operation. Thus, internal audit is a thorough examination of the accounting transactions to ensure that

- The transactions are properly recorded.
- The accounts are maintained systematically and
- There is no possibility for manipulation of accounts or misappropriation of property of the business.

In modern times, an internal auditor carries a new task. The traditional function of checking the arithmetical correctness of the accounts with the help of vouchers and documents and verification of few items such as stock, cash and fixed assets is not sufficient. The duty of internal auditor now is to chart the procedure, examine the efficiency and work on programs of improvement of assessing the effectiveness of controls. He is expected to plan and arrange his task for effective functioning, set clear objectives of his own section, phase his objectives, gain the confidence of the management and demonstrate the value of his functions in areas of performance. The internal audit is carried out generally in the same manner as is followed for a professional audit. However, it varies in form from enterprise to enterprise according to its size and specific needs. It is installed in large organisation and is carried out by the salaried staff who are qualified to conduct professional audit. Being the employee of the organisation he has to ensure that there is no waste in the organisation. Internal auditor has to follow the provisions of law, standard auditing practices and procedure prescribed for professional auditors and by the professional bodies controlling the audit system in the country. At the same time internal auditor must be aware of the policies and programs of the enterprise he should be professionally competent to carry out a detailed examination of the working of the business. Equipped with professional expertise and knowledge of the business, he will be in a better position to make the internal audit system more effective.

OBJECTIVES OF INTERNAL AUDIT

The main objectives of internal audit are as under:-

• To verify the correctness and authenticity of the financial records and statistical records presented to the management.

• To ensure that the standard accounting practices are strictly followed in the organisation.

• To facilitate early detection of errors and frauds.

• To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.

• To review the system of internal check from time to time to advice the management on improvement of the system and to undertake special investigation for the management.

• To confirm that the liabilities have been incurred by the organisation for legitimate activities.

Thus, efficiency of internal audit depends on the efficiency of the staff employed for the purpose, internal audit can be effective only if the internal auditor is given wider authority to investigate the transactions not only from financial angles but also from other organizational activities. Internal auditor should report directly to the top management. He must operate independently of the accounting and other staff. He must be given an independent status as an important functionary and a part of the management.

INTERNAL AUDIT V/S STATUTORY AUDIT

Internal audit helps the statutory audit to a large extent. Both the internal auditor and the statutory auditor have a common interest as far as authenticity of the accounts are concerned. However soundness of internal audit relieves the statutory auditor from detailed checking. The internal auditor reviews the operations and performs such functions as evaluation, compliance, verification and ensures that policies, procedures, rules and other type of controls of the business are carried out efficiently. He is helpful to statutory auditor in the matter of examination of books of accounts. Generally, the statutory auditor accepts some of the detailed checking made by the internal auditor. However, the area of cooperation between internal auditor and statutory auditor is somewhat limited as the statutory auditor has a responsibility under law to various authorities, while the internal auditor is responsible only to the management. The statutory auditor has to carry out his duties in accordance with standard accounting and auditing practices and provisions of law which govern the organisation. Before accepting the checking of accounts and other documents carried out by internal auditor, the statutory auditor must undertake such test checks necessary to find out the effectiveness of internal audit. Both internal auditor and statutory auditor carry out examination of records and documents and make physical and other verifications. Despite these similarities there are differences in the status, responsibilities, approach and scope of work of internal auditor and statutory auditor.