PRINCIPLES AND PRACTICES OF AUDITING

OCTOBER 2020

SECTION-A

Answer the following. Each question carries two marks :-

1. a) What do you mean by Auditing?

Ans. The word Audit has been derived from Latin word 'Audire'which means 'to hear'. Auditing means verification and examination of accounts. It is done to ascertain the reliability and validity of information. In other words, audit is an attempt to find out whether the financial statements reflect the true and fair result and financial position of the company or institution.

b) Define internal control.

Ans. According to W.W.Bigg: "Internal control is best regarded as indicating 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".

c) What is meant by vouching?

Ans. Vouching means, the examination of transactions recorded in the books of accounts in support of documentary in order to ascertain its authority, authenticity and accuracy. In other words, testing the truth of items appearing in the books of original entry with the support of documentary evidences is known as vouching.

d) Name two methods of valuation of assets.

Ans. The methods of valuation of assets are:-

1. Cost price
2. Market price.
3. Replacement value.
4. Book value.
5. Going concern value.

e) What do you mean by civil liability of an auditor?

Ans. An auditor is liable to the **following persons for negligence while discharging his duties**. To Third parties, if the auditor knows or had reasonable opportunity to know that he (the third party) is relying on the skill and judgement of the auditor. To his client, with whom he has contractual relationship.

Civil Liability of an Auditor for Misfeasance Means of Misfeasance Breach((break) of trust or duty imposed by law for negligence in the performance of duties, which results in **some** loss or damage to the company. As per section 543 of the companies act.

f) Give four examples of deferred revenue expenditure.

Ans. 1. Advertisement expenses.

2. Exceptional losses.

3. Fictitious Asset.

4. Preliminary expenses incurred before business incorporation include legal cost, professional fees, stamp duty etc.

5. Underwriting commission on issue shares and debentures.

g) What is continuous audit?

Ans. Continuous audit is a detailed examination of all the transactions by the auditor continuously throughout the year or at regular intervals say weekly, fortnightly, monthly, quarterly or as per the requirement of the management and scope of audit.

A continuous audit is an internal process that examines accounting practices, risk controls, compliance, information technology systems, and business procedures on an ongoing basis.

SECTION – B

Answer the following questions. Each question carries six marks:

2. Briefly explain the significance of cost audit.

Ans. Cost audit is an audit of cost accounting records. The significance of cost audit are:

1. Advantages of Cost Audit to the management:-

a. Cost audit provides reliable cost data for managerial decisions.

b. Cost audit helps management to regulate production.

2. Advantages of Cost Audit to the Shareholders:-

a. Cost audit enables shareholders to determine whether or not they are getting a fair return on their investments. It reflects managerial efficiency or inefficiency.

b. Cost audit ensures a true picture of company's state of affairs.

3. Advantages of Cost Audit to the Society

a. Cost audit improves the efficiency of industrial units and thereby assists in economic progress of the nation.

b. Cost audit tells the true cost of production.

4. Advantages of Cost Audit to the Government

a. Cost audit helps to ascertain whether any particular industry should be given any subsidy in order to develop that industry.

b. Cost audit provides reliable data to the government for fixing up the setting prices of the various commoditites.

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3. What are the objectives of Internal Control?

a. Transactions are executed in accordance with proper authorization.

b. To evaluate the system of accounting for complete authorisation of the transactions.

c. To review the working of the organization and the loopholes in the operation**s** and take necessary steps for its correction.

d. To ensure there is the optimum utilization of the firm's resources, i.e. men, material, machine and money.

e. Access to assets is permitted only in accordance with proper authorization.

f. To find out whether the financial statements are in alignment with the accounting concepts and principles**.**

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4. How do you vouch?

a. **Cash purchases**:-

i. The auditor should check the entries in the cashbook with the cash memo or receipted invoice supplied by the suppliers.

ii. The auditor must ensure that the net amount of purchase is entered in the cash book.

iii. The auditor has to make sure that the goods are received for the payment that is made and it is entered in the purchase book or stores ledger etc .

iv. He should see that the purchases are duly authorized.

v. He should see that the amount of payment made is recorded to the appropriate account.

b. **Payment to creditors**:-

i. The auditor must check the payments made to creditors against credit purchases with reference to the receipts issued by the creditors and the entries that are made in the purchase day book.

ii. He has to check for the evidence for the goods received in the purchase book or stores ledger.

iii. The auditor must ensure that the purchase of goods from the supplier is for the purpose of business only.

iv. Vouch the cash payment to creditors for the purchases.

c. **Purchase of building**:- Land may be purchased either on leasehold or freehold basis. In case the land is acquired under leasehold basis, auditor should study various terms and conditions of lease agreement. The payment made for leasehold land should be as per the terms of agreement. Auditor should vouch the payment with lease agreement and the receipt issued by the lessor. All the expenses incurred for acquiring the leasehold land should also be debited to leasehold land account.

Conveyance deed is prepared for the purchase of land on freehold basis. Auditor should vouch the payment for freehold land with the receipt issued by the seller and the amount paid should be compared with sale price as shown in conveyance deed.

d**. <u>preliminary expenses</u>:-**

i. Ensure that appropriate costs have been included in the preliminary expenses such as expenditure incurred incident to the creation, formation and floating of a company.

ii. Check board's minute book containing the resolution approving the expenses claimed the promoters as having been spend in the formation of the company.

iii. Examine supporting papers and vouchers, contracts, agreements etc to support the promoters'claim.

iv. Check receipt for the registrations fee paid from registration of the company.

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5. What are the points to be kept in mind while verifying the assets?

i. Confirm that the assets were in existence on the date of the balance sheet.

ii. Ascertain that the assets had been acquired for the purpose of the business and under proper authority.

iii. Confirm that ownership of the asset rests with the organization.

iv. Ascertain that no charge has been created on the asset.

v. Ensure that the current book value of the asset is determined after providing correct amount of depreciation for various years.

vi. Ensure that values reflect current physical condition of the asset.

vii. Ensure that disclosures regarding assets are adequate.

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6. Who is an Auditor? What are the disqualifications of company auditor?

Ans. An auditor is a person who is appointed to conduct an independent examination of books of accounts and supporting documents to report on the reliability and fairness of profit and loss account and balance sheet.

Section 226 (3) of the Companies Act, 1956 provides that none of the following persons shall be qualified for appointment as auditor of a company:

a) A body corporate other than LLP registered under the LLP Act, 2008

b) An officer or employee of the company.

c) A person who is partner or who in the employment, of an officer or employee of the company.
d) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel.
e) A person who has been convicted by a court of an offence involving fraud and a period often years has not elapsed from the date of such conviction.

SECTION -C

Answer the following questions. Each question carries fourteen marks:

7. Explain the various types of audit.

Ans. I. **Classification on the basis of the organisation:**

i. **Statutory Audit** : refers to the audit of an organisation performed under a statute.

ii. **Voluntary Audit**: Refers to the audit performed by the auditors because the proprietors of the organisation wants their accounts to be audited as it provides the assurance on the reliability of accounts and the financial results of the organisations.

II. Classification on the basis of the Functions:

i. **Internal Audit** : It is a type of audit conducted by the own staff of the organisation specially assigned for that purpose.

ii. **External Audit**: It is a type of audit performed by the auditors outside the business organisations. Qualified Chartered Accountants are appointed as external auditors of the organisation.

III. Classification on the basis of Audit Approach:

i. **Time basis :** a) **Continuous Audit**: This is also known as 'Detailed Audit'. Under this type, detailed examinations of books of accounts are conducted at regular intervals say weekly, monthly or once in three months.

b) **Interim Audit**: It is a type of audit which is conducted in between two annual audits with a view to find out the interim profits.

c) **Periodical or final or complete Audit**: It is a type of audit where the checking and verification of books of accounts are conducted only at the end of the accounting period.

ii. **Scope basis**: a) **Partial Audit**: Here auditor is asked to check and verify only few books of accounts for a particular work.

iii. **Objective basis:** a) **Balance Sheet Audit** : Here checking and verification of books of accounts starts from the balance sheet and working back to the original books of entry and other related documents. In this audit all the balance sheet accounts and the related items are verified.

b) **Occasional Audit:** It is a type of audit which is carried out whenever the clients desires it and whenever there is need.

IV **On the basis of Audit Dimension:**

i. Tax Audit: It refers to examining of an organisations or individuals incomes or expenses and claims of deductions or exemptions for the purpose of assessment of tax.

ii. Management Audit: It refers to the systematic examination of the activites of management at all levels of management. It covers all areas like Planning, organising, directing, controlling etc.

iii**. Cost Audit:** It means audit of cost records.

iv. System Audit: It is directed to ascertain whether they are up-to-date and economical.

v. Cash Audit: It involves the evaluation of all the cash transactions of the organisation for a given period of time.

vi. Social Audit: It is concerned with examination of performance of an organisation or an entity towards the fulfilment of social obligation.

vii. Energy Audit: This type of audit aims at evaluating whether the right type of energy is used in the organisation and also conforming that there is no waste of energy due to human difference.

viii**. Proprietary Audit:** The auditor examines the growth of the organisation in terms of production, sales and profitability of the organisation.

ix.Performance Audit: The auditor examines the growth of the organisation in terms of production, sales and profitability of the organisation.

x. **Secretarial Audit:** It is an audit which ensures that the corporate body’s legal requirements have been duly complied with and in time.

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8. What is internal check and what are its advantages and disadvantages?

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

Advantages :-

- Proper Distribution of Work: ...
- Detection and Prevention of Errors and Frauds: ...
- Increases Efficiency: ...
- Determination of Employees Liability: ...
- Proper Maintenance of Books of Accounts: ...
- Easy and Quick Presentation of Final Accounts: ...
- Facilitates the Auditor: ...
- Increases Profitability:

Disadvantages :-

1. Costly for small business.
2. Quality is sacrificed for promptness.
3. Carelessness among high officials.
4. Disorder in the working of a business.
5. Risky for an auditor.

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9. Explain vouching of receipts or debit side of cash book.

Ans. While vouching the cash receipts the following points are to be considered by an auditor:

a. If the rough book is maintained the auditor should ensure that the entries in rough and the cash book matches.

b. All the cash receipts should be properly recorded in the cash book.

c. He should ensure that the cash receipts are deposited into the bank daily. These deposits must be supported by the proper vouchers, i.e.pay-in-slip.

d. The auditor should check that the cashier do not have any control over the ledgers.

e. An auditor should check the entries in the pass book with the entries in the cash book. The bank reconciliation statement has to be prepared for the reconciliation of the bank balances shown by the cash book and the pass book.

f. The auditor should ensure that the receipts books are in printed form and the receipts are serially numbered and carbon copies are kept in the office.

g. The unused receipt books must be in the safe custody of a responsible officer.

h. The auditor must ensure that the cash discount given to the customers are recorded properly and at uniform rates.

i. The auditor should satisfy himself that the bad debts written off are authorised by an authorised person.

The following are the important items appear on the debit side of cash book

1. Opening balance.
2. Cash sales.
3. Receipts from debtors
4. Income from interest, dividends.
5. Rent received
6. Commission received
7. Sale of investments
8. Bad debts recovered
9. Sale of fixed assets
10. Income from hire purchase.

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10. Explain verification and valuation of

a) **Land and building**:-

In case of land and buildings, the auditor should verify the title deeds. If he is doubtful about it then may refer the matter to the solicitors of the company. If the property is mortgaged then he should take the certificate from the mortgagee to that effect. In case of building valuation, builder’s receipts and depreciation should be considered.

i) **Verification of Freehold Land and Buildings:-**

Auditor should verify the title deeds first. He should check that building is in the name of the client. He should vouch the addition made during the year in the building or land. If any land or building is sold during the year, he should vouch such sales. He should also verify that profit or loss on such sale is recorded correctly. He should also check the depreciation of the property.

ii) **Verification of leasehold land and buildings**:-

Auditor should verify the leasehold property by verifying the lease terms. He should note down the conditions of lease and check the property physically if possible. He should also verify the amount of debt received against the mortgage property and the duration period. Lease rental should be debited to the revenue account. He must verify the last receipt of the rent payment.

The following are the main way by which the auditor can verify the land and building:-

Title deed, confirmation, purchases, sale of buildings, profit or loss, construction cost, leased building, depreciaton, expenses of improvement, certificate of mortgage.

b) **Plant and machinery:-**

This item is also verified by reference to the original invoices, correspondence,etc. The auditor should see that plant and machinery is properly depreciated and all relevant details are recorded with documentary evidence from time to time.

Verification procedure:

a. Physical existence:- the auditor should check its physical existence of assets and confirm with the quantity and quality.

b. Purchases:- The auditor should check the vouchers.

c. Ownership:- The auditor can confirm the ownership by checking the vouchers or invoices.

d. Buying authority:- The management can only buy the machinery for the business purpose.

e. Additional Purchase:- The management can purchase and must be recorded in the books of accounts and in the register of the P&M.

f. Sale of Machinery:- The auditor has to check the register of P&M, vouchers of sale of plant, their amount and also the date.

g. Manufacture the machinery:- The auditor has to check the vouchers which is manufactured at the premises.

h. Checking of Balance:- The auditor has to check the opening and the closing balance with the help of previous year and current year books of accounts.

i. Profit or loss:- The auditor has to check the profit or loss if it is written in the books of accounts accurately.

j. Depreciation:- The auditor has to check that the rate and method is done according to the legal provisions from year to year.

c**. Goodwill:-**

Auditor's duty regarding verification

a. The goodwill as recorded in the books of account should be properly examined and the same is to be verified with the balance sheet.

b. Ascertain that the organization is justified in creating goodwill in its books of accounts.

c. In case of goodwill once written off, but later on brought back in order to write off the debit balance of profit and loss account or any capital loss, the auditor should investigate the reasons for this and may refer to the resolutions adopted at the board of directors meeting and the approval of the shareholders.

Auditor's duty regarding Valuation

a. The auditor should confirm himself that goodwill appearing in the balance sheet has not shown in excess of its cost price.

b. He should ensure that goodwill is valued at cost less amount written off. Goodwill is to be amortized over a period of time by debiting it to profit and loss account.

c. The auditor should see that the goodwill is never appreciated in the books of a company.

d. **Investments:-**

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted.

1. Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.

2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.

3. Balance this schedule and compare the balance with general ledger and Balance sheet.

4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.

5. Inspect the certificates or securities physically on the Balance Sheet date.

6. Compare the income received with amount due and adjust the accrued income.

7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.

8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.

9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.

10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.

11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.

12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.

13. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

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11. What are the qualifications and rights of company auditor?

Ans. Section 226 of the Companies Act, 1956 lays down the provisions with regard to the qualifications. Section 226(1) and (2) provides that the auditor must possess the following qualifications:

1. A person shall be eligible for appointment as an auditor of a company only if he is a Chartered Accountant:

Provided that a firm whereof majority of partners practicing in Indian are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

2. Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

<u>Rights of the Company Auditor</u>

According to section 227 (1) of the Companies Act, 1956, a company auditor has the following rights:

1. Right of Access to Books of Accounts:

Every auditor of a Company has a right of access at all times to the books of accounts and vouchers of the company whether kept at the head office of the company or elsewhere.

Thus, the auditor may consult all the books, vouchers and documents whenever he so likes. This is his statutory right. He may pay a surprise visit without informing the Directors in advance but in practice, the auditors inform the Directors before they pay their visits.

2. Right to obtain Information and Explanations:

He has a right to obtain from the Directors and officers of the company any information and explanation as he thinks necessary for the performance of his duties as an auditor. This is another important power in the hands of the auditor. He will, however, decide as to which information or explanations he thinks necessary to obtain. It the Directors or officers of the company refuse to supply some information on the ground that in their opinion it is not necessary to furnish it, he has a right to mention the fact in his report.

3. Right to Correct any Wrong Statement:
The auditor is required to make a report to the members of the company on the accounts examined by him and on every Balance Sheet and Profit and Loss Account and on every other document declared by this Act to be part of or annexed to the Balance Sheet or Profit and Loss Account which are laid before the company in General Meeting during his tenure of office. The Directors have a duty to prepare them and present them to the auditor.

4. Right to visit Branches:
According to section 228, if a company has a branch office, the accounts of the office shall be audited by the company's auditor appointed under section 224 or by a person qualified for appointment as auditor of the company under section 226.

Where the Branch Accounts are not audited by a duly qualified auditor, the auditor has a right of access at all time to the books, accounts and vouchers of the company and thus, may visit the branch, if he deems it necessary.

5. Right to Signature on Audit Report: Under section 229, only the person appointed as auditor of the company, or where a firm is so appointed, only a partner in the firm practicing in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

6. Right to receive Notice and other Communications relating to General Meeting and attend them:
Under section 231 an auditor of a company has a right to receive notices and other communications relating to General Meeting in the same way as a member of the company. He is also entitled to attend any General Meeting which he attends or any part of the business which concerns him as an auditor.

According to the power of the auditor, he may make any statement or explanation with regard to the accounts as he may desire. He need not, however, answer any questions.

Ordinarily, it is not necessary for the auditor to attend every General Meeting, but it will be good for him to attend meetings in the following circumstances:

(a) When his report contains important qualifications directly affecting the management, so that his remarks may not be misunderstood or misinterpreted.

(b) When he has received a notice from the company that someone else is going to be proposed for appointment as auditor of the company at the Annual General Meeting.

(c) When he has been specially asked by the management to be present.

7. Right of being indemnified:

Under section 633, an auditor (being an officer of a company), has a right to be indemnified out of the assets of the company against any liability incurred by him defending himself against any civil and criminal proceedings by the company if it is proved that the auditor has acted honestly or the judgement delivered is in his favour.

8. Right to have Legal and Technical Advice:
He has a right to seek the opinion of the experts and, thus, take legal and technical advice. This is necessary to give his opinion in his report. (Re. London and General Bank Case, 1895).

He has a right to receive his remuneration provided he has completed the work which he undertook to do.