

# PRINCIPLES AND PRACTICES OF AUDITING

SEPTEMBER 2021

## SECTION-A

Answer the following. Each question carries two marks:-

1. a. What is Audit Note Book?

Ans. Audit Note Book is a diary or register maintained by audit staff to note errors, doubtful queries and difficulties. The purpose is to note down various points which need to be either clarified with the client or the chief auditor. The audit note book is also used for recording important points to be included in the Auditor's Report. It is a complete record of doubts and their clarification.

b. What is Internal control?

Ans. Internal control is a broad term with a wide coverage. It covers the control of the whole management system. The control may be financial and or non-financial. It means internal control involves a number of checks and controls exercised in a business to ensure the efficient and economic working. It has become one of the basic and essential factors for efficient and effective management. It aids the organisation to meet its own goals more effectively.

c. State any four causes of depreciation.

Ans. 1. Wear and tear

2. Lapse of time

3. Obsolescence

4. Exhaustion

d. What do you mean by professional ethics?

Ans. Professional ethics refers to the professionally accepted standards of personal and business behaviour, values, and guiding principles. It encompasses the personal, organizational, and corporate standards of behaviour expected of professionals

e. What is Tax Audit?

Ans. Tax audit refers to audit of incomes or expenses or specific claims of deductions or exemptions for the purpose of assessment of income tax. Tax audit in addition to financial audit, which does not fulfil the specific requirement of the tax authority.

Tax audit came into force on 1/4/1985 u/s 44AB of the Income Tax Act, 1961. The scope of tax audit extends to verification of accounts of the previous year or years relevant to any assessment year.

f. What is primary voucher?

Ans. When written evidence is available in original, it is known as primary vouchers. For example: - cash memo, purchase invoice, goods received notes, counterfoil of cash receipts, purchase order, etc.

g. What is meant by contingent liability?

Ans. A contingent liability is a possible obligation that may arise in future depending on occurrence or non- occurrence of one or more uncertain events.

A contingent liability is a liability that may or may not happen. This means there is uncertainty about recording such a liability in the financial accounts. This is because the happening or not happening of a contingent liability is not in the hand of us.

## SECTION – B

Answer the following questions. Each question carries six marks :-

2. State the advantages of Audit programme.

Ans. **1. Audit Program Saves Time And Labor**

All the directions which are to be given to assistant are clearly stated in the audit program which helps to complete the task in time. Audit program also helps to conduct the audit of the business in coming years which saves time and labor.

**2. Audit Program Increases Efficiency**

All the responsibilities of auditor are divided among the number of staffs considering their skill and intelligence which helps to complete the work of audit properly. Similarly, the works are divided among the assistant staffs on the basis of their caliber which helps to increase efficiency.

**3. Audit Program Helps To Control**

An auditor can compare the work performed by the assistants on the basis of audit program which helps to control their work if there are any deficiencies.

**4. Audit Program Helps To Maintain Uniformity**

Works are divided among the assistant staffs; so there is no any chance of leaving non audited statements. If the work of audit is performed on the basis of audit program every year, uniformity can be maintained in the work of audit which helps to compare the report of various years.

**5. Audit Program Helps To Make Responsible**

Work of assistant is clearly defined in the audit program and assistant puts signature in the completed work. So, if any work is left out, assistant can be made liable for such work.

### **6. Audit Program Helps To Maintain Continuity**

Audit program clearly shows the completed task and procedures of doing work. So, if any staff leaves the job or remains absent, new staff can easily continue the job of audit.

### **7. Audit Program Helps To Present As Proof**

Auditor can present audit program as proof if he/she has been accused of misfeasance or negligence and can get clearance from such accusation. Audit program can be presented in the court also.

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3. How do you vouch petty cash payments?

Ans. The Petty Cash Book is vouched with the following objectives:

- a. Verification of actual cash balance with the balance appearing in Petty cash book.
- b. Whether the internal control system is effective in detection of frauds and misappropriations.
- c. Determining the validity and accuracy of transactions recorded in the petty cash book.

While vouching the payments from petty cash, the auditor should examine that:

- a. All vouchers are serially numbered and sanctioned by a responsible officer.
  - b. Petty cash received from the head cashier is recorded on the same day on which it is actually received.
  - c. Appropriate expense account is debited.
  - d. All the payments must be verified from the supporting evidence.
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4. State the objectives of verification of assets and liabilities.

Ans.

- a. Existence: auditor has to ensure himself that the assets are in existence at the date of the balance sheet and they belong to the client.
- b. Ownership: confirmation need to be obtained from the client showing that assets have been acquired for the business and are clearly stated in the balance sheet.
- c. Valuation: to satisfy himself that the assets are properly valued for the purpose of the balance sheet.
- d. Encumbrance: to verify that the assets which exist in financial statement are free from any change or encumbrances means it is not given as security for any debt/loans.
- e. Possession: To satisfy himself that the assets are in the possession or control of the client or in the custody of the persons authorized by him.

f. Recording: The assets recorded has been properly valued and authorized before recording in the books of accounts. The authorization of r ecording need to be checked.

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5. Distinguish between internal check and internal Audit.

Ans.

Internal Check	Internal Audit
1. It is an arrangement of duties allocated In such a way that the work of one person Is automatically checked by another.	1. It is independent appraisal of operation and records of the company.
2. The purpose of IC is to prevent and minimize possibilities of errors and frauds.	2. The purpose is to detect errors and frauds that are already committed.
3. IC doesn't require separate staff.	3. It requires separate staff employed only for this purpose.
4. IC is a continuous process.	4. Internal auditor has to report periodically about various inefficiencies and suggest improvements.
5. IC being along with the recording of transactions.	5. It begins when the accounting process ends.
6. It is devices of doing the work.	6. It is a device for monitoring the work.
7. Scope of internal check is limited especially to the accounting department.	7. The scope of internal audit goes on beyond accounting department.
8. Thrust of internal check system is to prevent the errors.	8. The thrust of internal audit system is to detect the errors and frauds.

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6. State the contents of Audit Note Book.

- Ans.
1. A list of books of accounts maintained by the clients.
  2. Notes on accounting method followed in the business.
  3. The names of the principal officers, their powers, duties and responsibilities.
  4. The technical terms used in business.
  5. The particulars of missing vouchers, the duplicate of which have to be obtained.
  6. Notes about all errors and frauds discovered.
  7. Total or balance of certain books of accounts, bank reconciliation statement etc.
  8. Difficulties observed and doubtful queries of various accounting records.
  9. Notes regarding items require explanations and clarifications.
  10. Any matter which requires discussions with the senior officials or with the auditor.
  11. Provisions in the Articles and Memorandum of Association affecting the accounts and Audit.
  12. Abstracts from minutes, contracts, etc, having a bearing upon accounts.
  13. Extracts from all correspondence entered into with the bankers, debtors, or creditors, Etc.
  14. Particulars of accounting and financial policies followed.
  15. Notes which may be of use in audits in future.
  16. A copy of audit programme.
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## SECTION – C

Answer the following questions. Each question carries fourteen marks :-

7. Explain the steps to be followed by an auditor before the commencement of a new audit.

Ans. Preparation before the commencement of new audit:

1. Receiving appointment letter: the auditors of the companies are appointed by the shareholders in the annual general meeting. Therefore, an auditor should get and examine the copy of resolution passed by the shareholders in the general meeting to confirm and should receive the appointment letter before starting a new audit.

2. Communication with the existing auditor: Communication with the existing auditor in case of an audit proposal is for an existing business, the proposed auditor must communicate with the previous auditor to know whether he has any objections to raise. It also an official requirement as per the ICAI Act 1949, and has to adhered to by the CA.

3. Acceptance of appointment: if the auditor is satisfied of the communication with the previous auditor, the auditor should confirm his acceptance through a letter of acceptance.

4. Ascertaining the scope of audit: an auditor should know the nature of audit of his client before starting the work. If the nature of audit is a statutory audit, the scope of audit work should be in accordance with the statute. In other types of audit, an auditor should discuss with his clients regarding the nature of audit work.

5. Knowledge about the organization: before determining a basic approach to audit, an auditor must have knowledge about the organization. He must familiarize himself with detailed knowledge of business, its activities and visit the location at which it operates. This helps him to know the nature of transactions which are recorded in the books of accounts.

6. Knowledge about accounting system: the system of accounting employed should be examined by the auditor before taking up the audit. He should obtain list of all books maintained by the organization for recording its accounting transactions. He must also acquire complete information about the internal control system of the organization.

7. Knowledge of technical details: the auditor must ensure that he has grasped all the technicalities peculiar to the business. Then only he will be in a position to identify the transaction of the accounting records.

8. Complete list of principal officers: Complete list of principal officers: the auditor should take the complete list of all the principal officers with their names duties and powers. He should also get their specimen signatures.

9. Observation of the previous auditor's report: If the company not a new but old, in this situation auditor should also inspect the report of previous auditor. This will help him in understanding the nature of accounts, important areas to which detailed checking is required and the techniques to be used to conduct the audit work efficiently.

10. Instructions to the client: after completing all the above steps, the auditor should issue clear instructions to the client that the accounts should be finalized and kept ready for audit.

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8. State the advantages and disadvantages of internal Audit.

Ans. Advantages

1. Internal audit is that it will lead to discovery of errors and therefore when external audit is done those errors which were discovered during internal audit would have been rectified by them.
2. Internal audit maintains a group of highly skilled people available to cope with non-recurring and exceptional jobs which no many employee could deal with efficiently and effectively.
3. It ensures that the organization detailed standard policy and procedures are running smoothly.
4. Since internal audit is done by the employees of company there is no additional cost involved.
5. As internal audit is a constant procedure where records are checked regularly it ensures that accounting staff of a company keep the records up to date.
6. No chartered accountant is required to audit internally.
7. Errors will be removed before preparing financial statements.
8. There will not be any type of embarrassment in the society because errors have been removed internally.
9. Internal audit increase investor's confidence.
10. It provides an excellent training ground for future executives.
11. It dispenses the need of employ external consultants to act as internal auditors hence saving large sum of money.

Disadvantages

1. Internal audit report is not accepted by either the shareholder or tax authorities, it is the external Auditor report which is required to be submitted to these parties.
2. Since internal audit is done by employees of company chances are that it may be biased and therefore company cannot depend on such reports.
3. Internal audit is not done by the professional auditor chances of internal auditor not detecting the errors are high.
4. Internal auditing can sometimes fail to check planned frauds.
5. Another disadvantage to audits is that they don't show the true picture and fails to disclose the correct information.

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9. How do you vouch the following items as an auditor?

Ans.

A) Sale of fixed assets :- Normally fixed assets are acquired with a view to maintain and retain for longer duration. But there may be occasional sale of fixed assets such as land, buildings, machinery, furniture etc.

Vouchers to be checked

1. Auctioneer's Note or Broker's Sold Note.
2. Sale Deed
3. Correspondence
4. Agreement of Sale
5. Minutes of Directors

B ) Receipts from Debtors :- This refers to cash collected from debtors. In case of credit sales, at the time of entering into the contract of sale, the terms and conditions of regarding sale of goods and payment will normally specified.

Vouchers to be checked

- a. Correspondence with debtors
- b. counterfoils of receipts book
- c. Sales Invoices
- d. Statement of customers accounts
- e. Existing and past discount charts , etc.

Duties of the Auditor

1. The auditor should verify whether all the receipts are deposited into the bank in the immediate following day.
2. He should ensure that the discounts given are at uniform rate to all debtors and that due authorization is obtained in case of higher discounts.
3. If a customer becomes insolvent, the amount due from him can be claimed through his Official Receiver. If possible, a part of the total amount due can be recovered in installments (dividends). The auditor can verify the same by examining the correspondence with the official receiver and the statement received from him.
4. If the debtors have not sent their statement of accounts, the auditor can contact the customers directly and ask for their confirmation of balance.
5. He should ensure that all bearer or other types of cheques received are immediately crossed as "Accounts Payee only".
6. He should also ensure that all the receipts are serially numbered. If any receipt is found to be missing, he should ask the clarification from the concerned officials.
7. In case of suspicion, the auditor should contact the customers directly with the approval of the client to verify the receipt of cash from them.

C) Rent received:-

An auditor has to verify the following documents while auditing rent receipts:

1. Rent Agreements
2. Counterfoils of Rent Receipts
3. Lease deeds
4. Rent rolls
5. Correspondence with the tenants.

Through the lease deeds and rent agreements, the auditor can gather details regarding the exact amount of rent, the amount to be collected towards amenities, the advance collected from the tenant, due date of payment of rent for every month etc.

### Role of auditor in vouching rent receipts

1. Cross verifying the counterfoils and rent receipts with rent rolls.
  2. Verifying that entries are made in the cash book immediately and everyday collections are deposited into the bank the next day.
  3. If rents are collected through agents, their statements should also be verified and tallied with the cash book entries.
  4. As there is a possibility that the rent collected may be misappropriated and shown as 'Rent Receivable', the auditor should obtain a confirmation statement from the tenant to verify the above.
  5. He should also check the entries of rent received in advance or accrued rent.
  6. Auditor should obtain a certificate, from the responsible officer regarding the period for which the property remained vacant.
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### 10. Explain the audit procedure of Educational Institutions.

Ans. Educational institutions include schools, colleges, training centers and universities. The main activities of these institutions are more or less similar to each other. However, on the basis of financial support and affiliation from the government, the educational institutions can be divided into the following groups.

- 1) Government institutions
- 2) Government-aided and affiliated institutions
- 3) Government unaided and affiliated institutions
- 4) Private institutions.

The auditor should conduct the audit of educational institutions, along with the followings steps:-

#### A) General consideration

- a. Study of the appointment letter
- b. Study of the constitution
- c. Inspection of minute book
4. Operation of bank accounts
5. Review of the internal check system

#### B) Audit of Receipts

- a. Receipts from admission fees
- b. Tuition fees received
- c. Advance and arrears of fee
- d. Recovery of fines
- e. Government grants
- f. Other fees received
- g. Exemption from fees and other charges



- h. Hostel dues
  - i. Donations received
  - j. Income from other sources
  - k. Refund of income tax.
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11. How do you verify and value the following items?

Ans.

a. Land and Building :-

Land means a long-term asset that refers to the cost of real property exclusive of the cost of any constructed assets on the property. The value of land has an appreciated value and is not subject to depreciation. A building is a noncurrent or long-term asset which shows the cost of a building (excluding the cost of the land). Buildings will be depreciated over their useful life of the asset.

Classified into two types

Land and Buildings can further be classified as –

A) Freehold property

B) Leasehold property

(A) Freehold Property

A property which is free from hold (Possession/Rights) is called as freehold property. This means that the property is free from the hold of anybody besides the owner who enjoys complete ownership.

Auditor's Duty

1. Where Freehold property has been purchased, the auditor should examine the title deeds e.g., purchase deed, certificate of registration, the broker's note and auctioneer's account etc., to verify the correct position.
2. When the property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed and outstanding amount of loan.
3. When the property has been acquired in the current year, then the cost may be verified with the help of the bank passbook. He should vouch all the payments made in this connection.
4. He should see that the property account should be shown in the Balance Sheet at cost price including the legal and registration charges less depreciation up-to-date.
5. He should also see that whether a separate account for building and land on which it is constructed is maintained. It is necessary because depreciation is provided for building and not for the land.

(B) Leasehold Property

Leasehold is an accounting term for an asset being leased. The asset is typically property such as a building or space in a building.

- The property which is on lease (rent).

- The property (plot/flat/villa/mall/ factories) which is leased by the landlord for a certain period of time to the lessee (tenant /leaseholder/renter/ occupant/dweller).
- The (tenants) have been given the right to use during that specified time by the landlord.

### Auditor's Duty

1. The auditor should verify this by inspecting the lease agreement or contract to find out value and duration. He should see that the terms and conditions of lease are properly complied with.
2. In case property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed.
3. Where the leasehold property has been sub-let, the counter part of the tenant's agreement should also be examined.
4. The auditor should physically inspect the properties.
5. The auditor should also note that proper provision has been made for depreciation of lease problem and for any possible claims arising there under.

b. Goodwill :- It means the reputation of the business reflected by the profit earning potential and operating efficiency. It is an intangible asset. The other factors that influence goodwill are location, nature of goods, risk involved, competition, competing potentials, trend of profit and personal and impersonal effects.

Goodwill is defined as the monetary value attached to the reputation of a business or as the difference between the purchase price and the net assets which are purchased and the excess amount so paid.

- a. Accounting standard 10: It should be verified that the goodwill has been recorded in the books of accounts only when some consideration in money or its equal has been paid for. As required by AS-10 issued by ICAI on fixed assets, goodwill is recorded in the books only when some consideration in money or money's worth has been paid.
  - b. Partnership firm: In the case of partnership firm the partnership deed should be duly verified by the auditor. He may also verify the changes made in the goodwill account from time to time on the basis of provisions of partnership deed.
  - c. Written off: Valuation of goodwill should be made at cost less amount written off. An auditor cannot insist on written off the goodwill, but if it appears to him that the future benefits is non-existent, he should insist on the account being written off. Moreover, sound financial policies require that the amount of goodwill should be gradually written off over a reasonable period of time.
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