# PRINCIPLES AND PRACTICE OF AUDITING

**OBJECTIVE:**

This subject aims at imparting knowledge about the principles and methods of auditing and their applications.

**Unit 1: INTRODUCTION TO AUDITING** **12 Hrs**

Introduction – Meaning - Definition – Objectives – Differences between Accountancy and Auditing – Types of Audit - Advantages of Auditing – Preparation before commencement of new Audit – Audit Notebook – Audit Working Papers – Audit Program, Recent Trends in Auditing: Nature & Significance of Tax Audit – Cost Audit - Management Audit.

**Unit 2: INTERNAL CONTROL** **10 Hrs**

Internal Control: Meaning and objectives. Internal Check: Meaning, objectives and fundamental principles. Internal Check as regards: Wage Payments, Cash Sales, Cash Purchases. Internal Audit: Meaning - Advantages and Disadvantages of Internal Audit – Differences between Internal Check and Internal Audit.

**Unit 3: VOUCHING** **12 Hrs**

Meaning - Definition – Importance – Routine Checking and Vouching – Voucher -Types of Vouchers – Vouching of Receipts: Cash Sales, Receipts from debtors, Proceeds of the sale of Investments. Vouching of Payments: Cash Purchases, Payment to Creditors, Deferred Revenue Expenditure.

**Unit 4: VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES** **12 Hrs**

Meaning and Objectives of verification and valuation– Position of an Auditor as regards the Valuation of Assets – Verification and Valuation of different Items: Assets: Land & Building, Plant & Machinery, Goodwill – Investments - Stock in Trade. Liabilities: Bills Payable - Sundry Creditors – Contingent Liabilities.

**Unit 5: AUDIT OF LIMITED COMPANIES AND OTHERS** **10 Hrs**

Company Auditor – Appointment – Qualification - Powers - Duties and Liabilities – Professional Ethics of an Auditor. Audit of Educational Institutions – Audit of Insurance Companies- Audit of Co- operative societies.

**SKILL DEVELOPMENT:**

- Collect the information about types of audit conducted in any one Organization
- Visit an audit firm; write about the procedure followed by them in Auditing the books of accounts of a firm.
- Draft an investigation report on behalf of a Public Limited Company
- Record the verification procedure with respect to any one fixed asset.
- Draft an audit program.

# INTRODUCTION TO AUDITING

Auditing is a system of control exercised on the book-keepers. That is the business transactions are carried on by the employees, who may involve in frauds and misappropriations of funds belongs to the business. Therefore to control such activities and to protect the proprietors themselves, the process audit has been brought into existence.

**Origin of audit**: The historical records of Greek and Rome reveals the existence of audit system even in the ancient period. During that period Audit was used in the field of govt. to keep control on the cash transactions of govt. that is revenues and expenses of govt.

The increase in the volume of transactions in the private sector, leads to apply the audit system in the private sector. The Audit has brought into the private sector to control the misuse of cash and properties of the business.

**Meaning of audit:**

(**Traditional concept). **The term audit is derived from the **Latin word "AUDIRE"** it means "**to hear". **That is during the ancient period some learned persons called as judges are appointed to hear the accounts (called as hearers or auditors) maintained by the book-keepers, on the basis of the hearing (audit) those judges are going to give their own judgment.

**Modern concept:** as per modern concept, Audit is too wider than the traditional concept. It includes not only checking of cash, but also verification of books of accounts, and the original source of transactions by an independent qualified auditor and reporting to the management.

An examination and verification of a company's financial and accounting records and supporting documents by a professional, such as a certified chartered Accountant.

**Definitions of audit:** the important definitions on auditing are:

1. **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".
2. **SPICER and PEGLER defined auditing** as "an examination of books of accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, so as to give true and fair view of that state of affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as is shown by the books, and if not, in what respects he is not satisfied".

3. **Statement on Standard Auditing Practices (SAP) 1 by ICAI** "Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."
4. **Mautz** defines auditing as being "Concerned with the verification of accounting data with determining the accuracy and reliability of accounting statements and reports."
5. **A.W.Hanson defined auditing as,** "An Audit is an examination of accounting records to establish their reliability and the reliability of statement drawn from them".
6. **F.R.M. De Paula defines auditing as** "an audit denotes the examination of a balance sheet and profit and loss account prepared by others together with the books, accounts and vouchers relating thereto in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion. Such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern according to the information and explanations given to him and as shown by the books.

**Conclusion**: the analysis of all the definitions given on the term audit reveals that the audit is a critical examination of books of accounts of a business by an independent qualified person for ascertaining the authenticity and the accuracy of the entries appearing in the books of accounts and the financial statements, and reporting to the owners of the business whether the financial statements give a true and fair view of the profit or loss of the business for the financial period and the financial positions of the business at the end of the financial period.

## FEATURES AND IMPARTANCE OF AUDITING

1) Audit is a systematic and scientific examination of the books of accounts of a business;
2) Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
3) 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.
4) Audit is a critical review of the system of accounting and internal control.
5) Audit is done with the help of vouchers, documents, information and explanations received from the authorities.
6) 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.
7) The auditor has to inspect, compare, check, review, scrutinise the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts

## ADVANTAGES OF AUDITING:

1. **Verification of Books and Statement: -** The main object of audit is the verification of the books and the financial statements of the company concerned.
2. **Discover and Prevention of Error: -** While examining the books, auditors detect some errors. These are various kinds of errors. So audit is very useful in preventing and detecting the errors.
3. **Discovery and Prevention of Fraud: -** Fraud means false representation made intentionally with a view to defraud somebody. It is the duty of the auditor that he should detect the fraud. So audit main object and advantage is that fraud may be detected and prevented. Auditor may also suggest various methods of internal check which will prevent fraud.
4. **Moral Check: -** When each staff of the company knows that these financial transactions will be examined by the auditor then he fears to do that fraud. The fear of their detection acts as a moral check on the staff of the company.
5. **Independent Opinion: -** Auditing is very useful to obtain the independent opinion of the auditor about the business condition.

   If the accounts are audited by the independent auditor, the report, of the auditor will be a true picture and it will be very important for the management. Keeping in view the report, owner of the business will be able to prevent frauds and errors in future.
6. **Protects the Interest of Share Holder: -** Audit protects the interest of shareholders in the case of Joint Stock Company. Through audit shareholders are assured that the accounts of the company are maintained properly and their interest will not suffer.
7. **Check on Directors: -** Audit acts a check upon the directors and precaution against fraud on the part of the management.
8. **Proper Supervision: -** Sometimes owner of the business cannot look after the business personally. Audit acts as a check on employees and it saves the owner from losses.
9. **Valuable Advice: -** The auditor has expert knowledge about the accounts and finance problems, so he may be consulted about these problems.
10. **Disputes Settlement: -** In case of partnership, audit is very useful in settling the disputes among the partners. If any partner dies, or retires, the audited balance sheet will be very useful in estimating the value of goodwill.
11. **Loan Facility: -** If accounts are audited, then true picture will be known to the financial institutions and they will never hesitate to lend the money.
12. **Insurance Claim: -** In case of fire insurance and participation of fraud claims can be settled on the basis of audited accounts of the previous years.
13. **Property Value Assessment: -** If the accounts have been audited, then it is easier to value property when the business is sold. In the eyes of law audited accounts are considered more reliable.

14. **Correct Information about Business: -** Due to the fear of audit work accounting always remains up to date and correct information is given to the members in time.
15. **Advantage for General Public: -** Audited financial statements present the real position of the company before the general public. Keeping in view the position of a company one can do the investment.
16. **Useful for Tax Department: -** Assessment of tax becomes very easy job for the tax department. Keeping in view the audited accounts they impose the taxes.

## DISADVANTAGES OF AUDITING:

It is true that auditing as many advantages, but it as some limitations as such

1. **Non-detection of errors/frauds: -** Auditor may not be able to detect certain frauds which are committed with malafide intentions.
2. **Dependence on explanation by others**:- Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.
3. **Dependence on opinions of others: -** Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, and Architects etc. he cannot be an expert in all the fields
4. **Conflict with others:** - Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgment plays an important role. It differs from person to person.
5. **Effect of inflation**: - Financial statements may not disclose true picture even after audit due to inflationary trends.
6. **Corrupt practices to influence the auditors**: - The management may use corrupt practices to influence the auditors and get a favorable report about the state of affairs of the organisation.
7. **No assurance**: - Auditor cannot give any assurance about future profitability and prospects of the company.
8. **Inherent limitations of the financial statements**: - Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts cannot be measured. Audited statements due to these limitations cannot exhibit true position.
9. **Auditing is a post-mortem examination**: auditing work begins where accounting ends then the auditor is fully depends upon the accounting transaction provided by the accountant in the throughout the year. So auditing work is not suitable for the current position of the business. But it is useful to the future business situation.
10. **Detailed checking not possible**: - Auditor cannot check each and every transaction. He may be required to do test checking.

## DIFFERENCE BETWEEN AUDITING AND ACCOUNTING OR DIFFERENCE BETWEEN ACCOUNTANT AND AUDITOR:-

| Basis | Accounting | Auditing |
|---|---|---|
| **1. Meaning** | Accounting means the maintaining of the books of accounts | Auditing means examining the books of accounts and reporting means to report about their accuracy. |
| **2. Performance Of Work** | Accountant job is performed by the accountant | Auditing job is performed by the auditor |
| **3. Appointment** | Accountant is appointed by the management | Auditor is appointed by the share holders |
| **4. Nature Of Job** | Accountant job is a mechanical nature | Auditor job is not so mechanical in that sense |
| **5. Qualification** | For the accountant no specific qualification is required | For the auditor specific qualification is required |
| **6. Responsibility** | Accountant responsibility is fixed by the management | Auditor responsibility is fixed by law |
| **7. Submission Of Report** | Accountant is not required to submit any report | Auditor is required by law to submit the report |
| **8. Fixation Of Rights** | Rights and duties of accountant are fixed by the management. | Rights and duties of an auditor are fixed by the law |
| **9. Time** | In case of accounting, period is usually one year | The period of auditing is usually less than one year |
| **10.Purpose** | Accounting purpose is to show the financial position of the business. | Auditing verifies the true picture of the financial statement |
| **11.Record/Data** | Accounting is related with the present record | Auditing verifies the true picture of the financial statement. |
| **12.Employment** | Accountant is a permanent employee | Auditor is not a permanent employee |
| **13.Liability** | After preparing the final accounts accountant has no liability | Auditor has liability after presenting the audit report |
| **14.Rules** | Accounting is not governed by code of conduct laid down by the institute | Auditing is governed by the charted accountant code of conduct |
| **15.Evaluation** | The accountant cannot determine the efficiency of its own function | Auditor also cannot determine the efficiency of its own function but he can determine the efficiency of all the business |

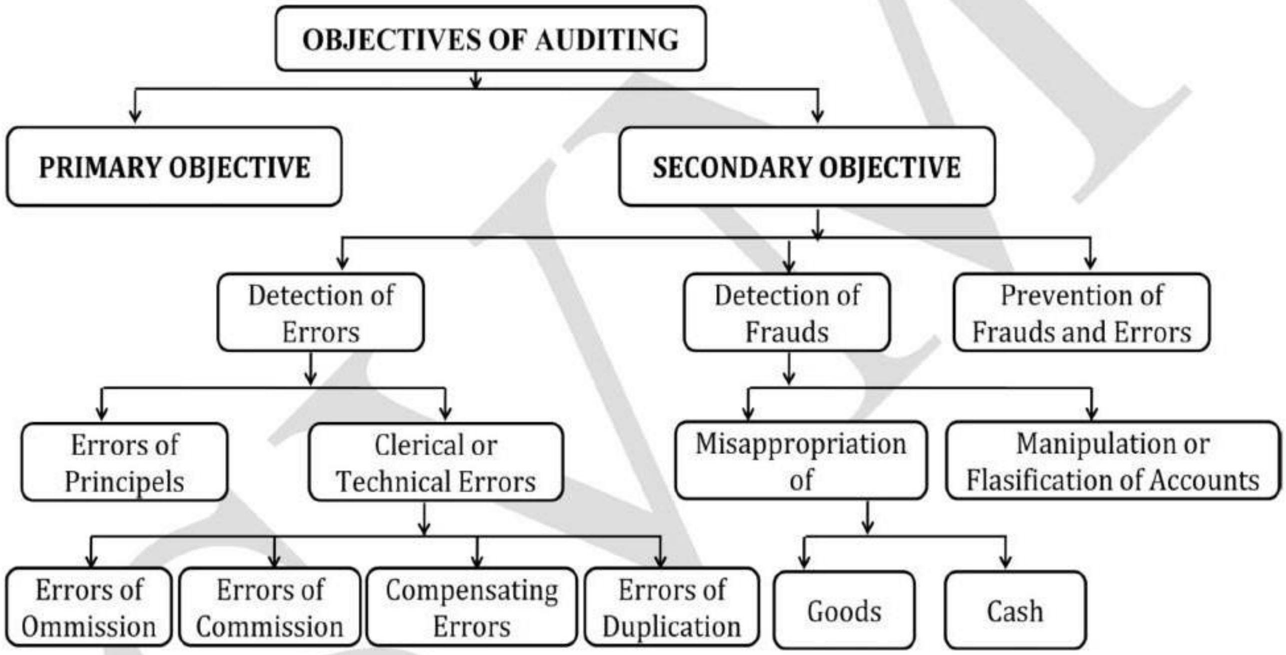


"Be not afraid of growing slowly; be afraid only of standing still"

| | | |
|---|---|---|
| **16. Methods** | Accounts uses the method of valuation and depreciation | The auditor uses manual and computerized method |
| **17.Knowledge** | Accountant must have the knowledge of accountancy | Auditor must have the knowledge of accounting as well as auditing. |
| **18. Removal** | Accountant can be removed from his job at any time | Auditor cannot be removed till the completes his period of appointment |

## OBJECTIVES OF AUDITING

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



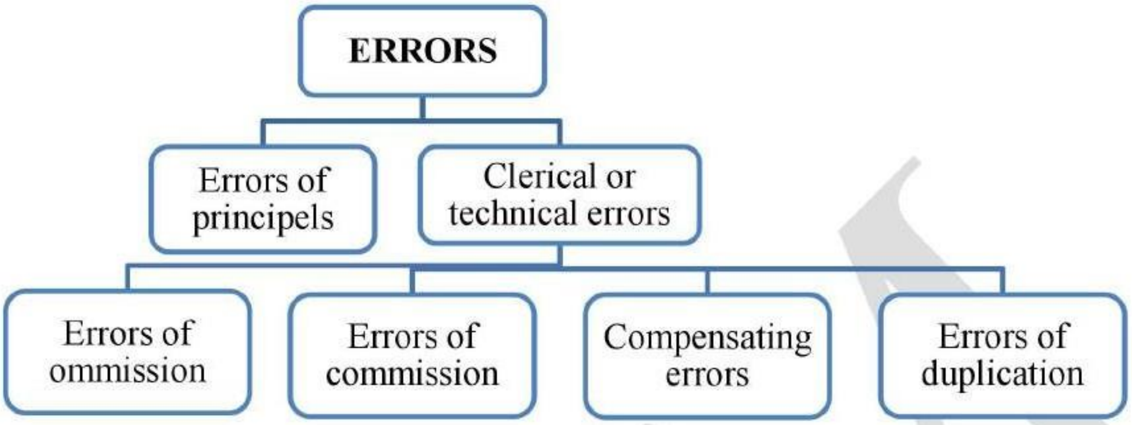

I. **Primary objective**: - As per Section 227 of the Companies Act 1956, the primary duty (objective) of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company's state of affairs and the profit and loss A/c gives a correct figure of profit of loss for the financial year.

II. **Secondary objective**: - it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objectives of auditing are:

- ⇨ Detection of Errors,
- ⇨ Detection of Frauds, and
- ⇨ Prevention of Frauds and Errors.

## DETECTION OF ERRORS:

Error refers to unintentional miss-statements or miss-descriptions in the records or books of accounts by the books keepers. In other words, they are unintentional mistakes arising on account of negligence or ignorance. Errors may be basically of two types:




**I. Principal Errors**: these errors arise generally when the principals of accountancy are not observed while recording a transaction. For instance a capital expenditure is recorded as revenue expenditure or vice versa. Such errors are difficult to detect as the Trial Balance tallies inspite of such errors.

Basically it arises on account of ignorance of accounting principles. Following are the examples of principles errors:

→ Incorrect allocation of expenditure between capital and revenue (Revenue receipt is recorded as a capital receipt).

→ Valuation of assets against the fundamental principles of accountancy. (Overvaluation or undervaluation of stock on account of ignorance)

→ Wages paid for installation of plant and machinery is recorded as wages paid to workers

→ Incorrect provisions for doubtful debts and discount on debtors

→ Rent paid to landlord debited to the landlord account instead of rent ac account

**II. Clerical Errors: -** These errors arise on account of negligence of the accounting staff. They are called technical errors clerical errors may be further divided as errors of omission, Errors of Commission, Duplicating Errors and Compensating Errors.

1) **Errors of Omission:** These are the errors which arise on account of transaction into being recorded in the books of accounts either wholly or partially. If a transaction has been totally omitted it will not affect trial balance and hence it is more difficult to detect. On the other hand if a transaction is partially recorded, the trial balance will not agree and hence it can be easily detected.

**Detection: -** An auditor may detect the error by comparing the data of previous with this item. We may say that critical analysis of the auditor locate such type of errors

2) **Errors of Commission:** an error of commission is one where a transaction has been recorded but mistake has been committed in recording it in the books of original entry or in posting there from to ledger. E.g.: wrong entries, wrong Calculations, postings, carry forwards etc such errors can be located while verifying.
   **Detection**: - Such errors can be detected by checking the arithmetical accuracy of the original books. It can also be discovered when somebody challenges the transaction.
3) **Error of duplication:** error of duplication arises if the same transaction is recorded twice in the books of original entry and also posted twice in the ledger.
   **Detection**: - careful vouching is the only answer to detect duplication error.
4) **Compensating Errors:** when two/more mistakes are committed but those errors are counter balances each other. Such an error knows a Compensating Error. E.g.: if the amount is wrongly debited by Rs 100 less and Wrongly Credited by Rs 100 such a mistake is known as compensating error.

## PROCEDURE TO BE FOLLOWED TO DETECT THE ERRORS

Following procedures may be adopted by the auditor to detect the errors.

1. Check the opening balances from the balance sheet of the last year.
2. Check the posting into respective ledger accounts
3. Check the total of the subsidiary books.
4. Verify all the castings and the carry forwards.
5. Ensure that the list of debtors and creditors tally with the ledger accounts.
6. Make sure that all accounts from the ledger are taken into accounts.
7. Verify the total of the trial balance.
8. Compare the various items from the trial balance with that of the previous year.
9. Find out the amount of difference and see whether an item of half or such amount is entered wrongly.
10. Check differences involving round figures as Rs. 1,000; Rs. 100 etc.
11. See where there is misplacement or transposition of figures that is 45 for 54; or 81 for 18 etc.
12. Ultimately careful scrutiny is the only remedy for detection of errors.
13. See that no entry of the original book has remained un-posted.

## DETECTION OF FRAUDS

The term fraud means the willful misrepresentation made with an intention of deceiving others. It is a deliberate mistake committed in the accounts with a view to get personal gain. In accounting, fraud means two things.

**FRAUDS**

- Misappropriation of
  - Goods
  - Cash
- Manipulation or Flasification of accounts

**I. Misappropriation of cash or Embezzlement of cash: -** This is one of the majored frauds in any organisation it normally occurs in the cash department. This kind of fraud is either by showing more payments/ less receipt. The cashier may show more expenses than what is actually incurred and misuse the extra cash.

The following are some of the examples of Misappropriation of cash:

- **By inflation payments:** either by inflating purchase invoices or by inflating any other expenses being paid, or by inflating wages sheets by including the names of dummy workers or using fictitious vouchers.
- **By suppressing receipts:** this is done by
  1. Cash sales being not fully accounted
  2. Adjusted unauthorised rebates, allowances, discounts etc. in the customers accounts
  3. Not accounting miscellaneous receipts, for example sale of scrap, sale of news paper and magazines etc.

**II. Misappropriation of Goods: -** It refers to fraudulent application of goods by those who handle them. It can be done by recording sales of larger quantities and misappropriating the balance or by recording purchase of large quantities receiving less quantity and then receiving the balance amount privately.

Here records may be made for the goods not purchase not issued to production department, goods may be used for personal purpose. Such a fraud can be deducted by checking stock records and physical verification of goods.

**III. Manipulation of Accounts: -** this is finalising accounts with the intention of misleading others. This is also known as "WINDOWS DRESSING". It is very difficult to locate because it's usually committed by higher level management such as directors. The objective of WD may be to evade tax, to borrow money from bank, to increase the share price etc.

Some of the following examples of falsification of accounts are:

1. Recording fictitious sales or purchases.
2. Charging more or less amount as depreciation or provisions.
3. Creation and utilisation of secret reserves

4. Overvaluation or undervaluation of assets and liabilities.
5. Not recording currents year's accrued expenses etc.
6. Showing expenses of the next year in the current year's profit and loss account
7. Recording revenue expenditure as capital expenditure

**THE AUDITOR SHOULD PERFORM THE FOLLOWING DUTIES IN RESPECT OF FRAUD.**

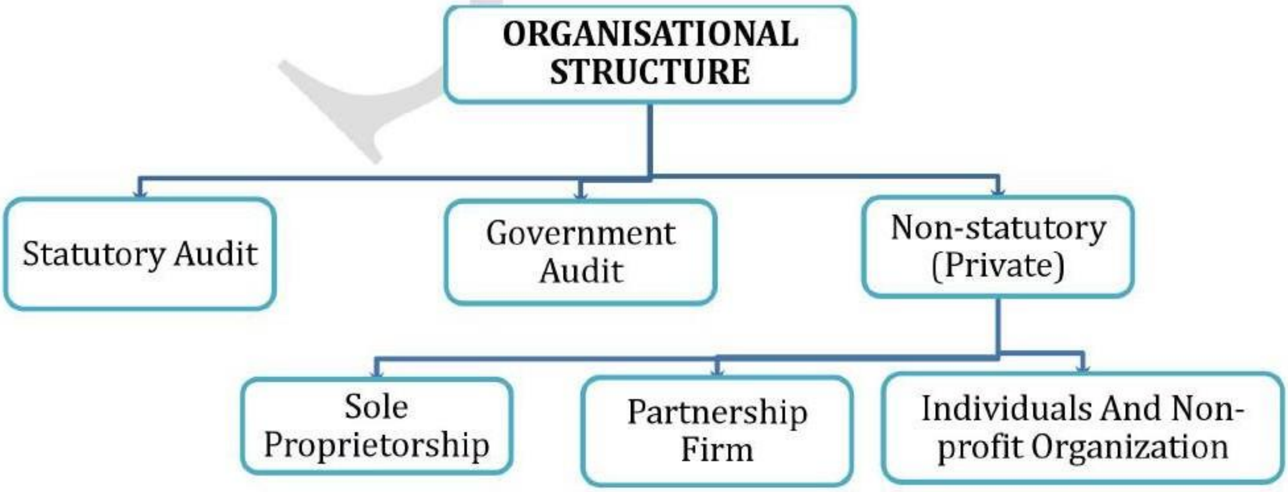
1. Examine all aspects of the finance.
2. Vouch all the receipts from the counterfoils or carbon copies or cash memos, sales mart reports etc.
3. Check thoroughly the salary and wages register.
4. Verify the methods of valuation of stocks.
5. Check up stock register, goods inwards notes, goods out wards books and delivery challans etc
6. Calculate various ratios in order to detect fraudulent manipulation of accounts
7. Go through the details of unusual items.
8. Probe into the details of the problems when there is a suspicion.
9. Exercise reasonable skill and care while performing the duty.
10. Make surprise visit to check the accounts.

**PREVENTION OF ERRORS AND FRAUDS**

Lastly, the duty of an auditor is not only to detect errors and frauds, but also to prevent them. This is possible with in-depth study of the internal check system, thereby the auditor puts a moral check on the staff. The auditor can thus offer suggestions for making improvements in the internal control system.

**TYPE OR CLASSIFICATION OF AUDIT:**

**I. FROM THE POINT OF ORGANISATIONAL STRUCTURE**



## ⇨ Statutory Audit:

Statutory Audit is **compulsory audit** prescribed under statute i.e. law. Appointments of auditors, removal, remuneration, rights, duties, liabilities are governed as per the Provisions of the respective law applicable to the organisation. Scope of the audit work and all others terms are as laid down by the law. It can be conducted only by a qualified Chartered Accountant.

Statutory audit is **conducted after preparation of final accounts.** Statutory auditor has to report whether the balance sheet and profit and loss A/c are drawn upon conformity with law and whether they show true and fair view. Statutory auditor has to submit report to the shareholder. His remuneration is fixed by shareholder. The concerns and the corresponding Acts are as shown in the following Exhibit:

Exhibit [1.1] statutory audit

| No. | Concern | Act |
|---|---|---|
| 1 | Companies<br>→ Financial audit<br>→ Special audit<br>→ Cost audit | Companies Act, 1956<br>- S.227<br>- S.233A<br>- S.233B |
| 2 | Banks | Banking Companies Regulation Act,1949 |
| 3 | Insurance Companies | Insurance Act,1938 |
| 4 | Co-operative Societies | Respective State Co-operative Act |
| 5 | Public Charitable Trusts | Indian Trust Act etc. |
| 6 | Statutory Corporations | Special Act of Parliament e.g. Life Insurance Corporations. |
| 7 | Electricity Companies | Electricity Supply Act, 1948 |
| 8 | Registered Societies | Societies Registration Act |
| 9 | Tax Payers | Tax Audit under Income-tax Act |

## ⇨ Government Audit

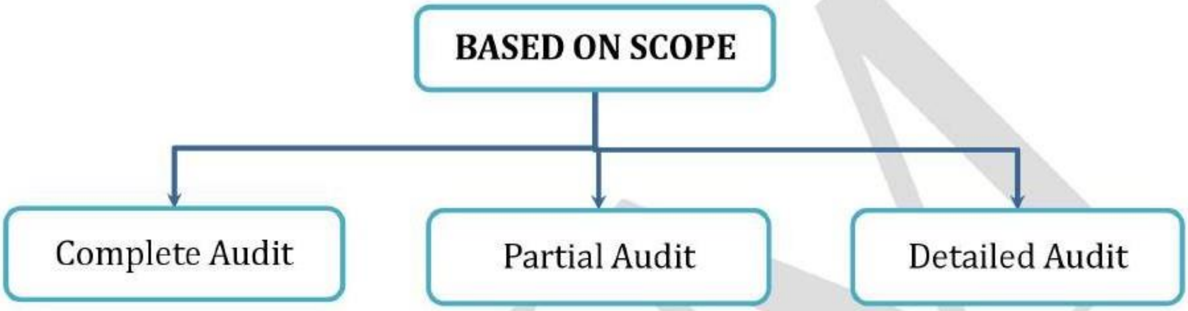
**Meaning and Scope:** Government audit is a **control measure for public accounting of government funds.** It covers the audit of all expenditure and receipts done by the executive and audit of commercial accounts maintained by public enterprises. Public enterprises are classified under three categories department undertaking, statutory corporations financed by government and government companies set up under the Companies Act, 1956.

**Who conducts it:** In India, the Accounts and Audit Department of the Government of India, headed by the **Auditor General of India (CAG), carries the audit work.** The CAG's duties have been specified by the Comptroller and Auditor General's Act, 1971

### ⇨ Non-statutory audit:

Non-Statutory Audit is **voluntary audit.** They are not compulsory under any law. It is carried at the discretion of the proprietor terms and conditions of the audit are determined as per the agreement made between the auditor and proprietor. Example: **Financial audit of the sole trader and partnership firm.** Voluntary audit also covers non-financial audit. Internal audit, management audit, social audit, operational audit etc.

## II. FROM THE POINT OF SCOPE OF AUDITING




### ⇨ Complete Audit:

In this type of audit, the auditor is required to check each and every transaction recorded in the books of accounts. He has to examine each and every voucher, document or correspondence relating to the transaction. This type of audit is not possible for large sized organizations.

### ⇨ Partial Audit:

In Partial audit, the auditor is not required to examine all the books of accounts. Only a part of the accounts or some transactions as desired by the clients may be scrutinized. Auditor has to state the area covered by the audit.

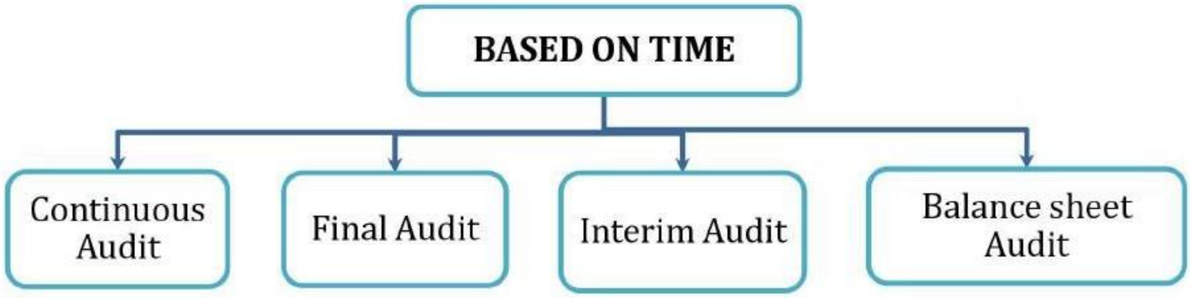
This type of audit cannot be followed in the case of statutory audit. It may be followed in the case of statutory audit. This audit is not convenient when the audit is legally required.

### ⇨ Detailed Audit:

Under detailed audit, few business transactions are examined in detail by the auditor. **Spicer and Pegler** have defined it as, "An audit which starts with books of prime entry and ends with the balance sheet. The checking sequence is arranged in order of recording the transactions in the primary book".

Thus, for the purpose of detailed audit certain transactions are traced through various stages from beginning to their end with the help of available evidence. This technique of examination is also called audit-in-depth.

## III. FROM THE POINT OF TIME




### ⇨ Continuous / running Audit:

Audit means an audit at regular intervals throughout the accounting year. Generally, the audit work begins after the accounting year is over. But in case of Continuous Audit, the work begins the accounting year itself.

Continuous audit is defined by **R.C. Williams** as one where the auditor is constantly or at (regular or irregular) intervals engaged in checking the accounts during the period.

**Necessity of Continuous Audit:**

Continuous Audit is necessary in the following cases-

- **a)** Where the volume of transaction is very large and complex.
- **b)** where the management requires monthly or quarterly audited statements of accounts or the statements of accounts are required immediately after the accounting year;
- **c)** Where the system of internal control or internal check is weak.
- **d)** Sometimes continuous audit becomes necessary for self-survival against cut-throat business competition.
- **e)** When interim dividend is to be declared.

**Advantages of Continuous Audit:**

- **A. Quick Preparation of Final accounts:** Since, the routine audit is done continuously; the Final Accounts can be prepared immediately after the year end.
- **B. Early Dividends to Shareholders:** The shareholders would be happy as they receive dividends soon after the end of the financial year. The Company can prepare interim accounts and pay even interim dividends to the shareholders.
- **C. Up-to-date Accounts for Banks/Investors:** The up-to-date final accounts are useful to banks and investors for taking decisions regarding loans and investment.
- **D. Check on Employees:** Since the auditors visit regularly throughout the year, it acts as check on the employees to keep the accounts ready and up-to-date.
- **E. Prevents Errors and Frauds:** Constant checking by the auditors helps to detect and even prevent errors and frauds.

F. **Familiarity with Client's Business:** Since the auditor spends more time at the client's place, he becomes familiar with all the aspects of client's business.
G. **Thorough Audit:** The auditor has more time at his disposal to do a thorough checking of all transactions. This reduces the risk of missing any material items.
H. **Utilization of Audit Staff:** Audit Staff can be kept busy throughout the year. Audit work can be evenly distributed to avoid overwork after year end.

**Disadvantages of Continuous Audit:**

1. **Expensive**: Since the auditor spends more time on the audit work, the audit fees are much more. Continuous Audit is thus expensive. However, only a large organization should opt for a Continuous Audit.
2. **Audit in Installments**: Since the audit work is done at intervals and not at one go, audit may be inefficient. The queries during the last visit may remain unsolved. It is difficult at each visit to take up the work precisely at the stage of last visit. To overcome this disadvantage, audit should be well-planned. All queries should be noted in the Audit Note Book and cleared before taking up fresh work. The work done up to end of each visit, relevant voucher numbers, totals etc. should be carefully noted in the Audit Note Book.
3. **Dislocation of client's work:** If a proper audit programme is not adopted, continuous audit may disrupt the routine accounting work of the client. Either the audit staff may have to sit idle or the accounts staff of the client may waste time for want of books of accounts. Employees have to attend the auditor for explanation. They have to keep aside their usual work to attend the auditors for explanation.
4. **Errors and Frauds in Books Already Checked**: If an employee changes some figures in the books already checked by the auditor during his earlier visits, it would be difficult to detect such errors and frauds subsequently.
5. **Monotonous- tiresome-tedious:** Continuous visits to the client's place may make the work tedious and the audit staff loses interest from work consequently. The quality of audit suffers.
6. **Absence of link:** In the absence of well-planned audit work, an auditor may miss the thread of audit work. Further, some important queries may be overlooked if no proper audit notes and queries are recorded by the audit staff during the course of the audit.
7. **Conflict between audit and accounts staff:** The members of audit and accounts staff come in close contact and sometimes it may result in spoiling the healthy relations between them and thereby the quality of audit may suffer.
8. **Dependence of the accounts staff on the auditor:** The accounts staff may depend on the audit staff. They may require the help of auditor for even small errors which they can discover or avoid by taking proper care.

## ⇨ Final / Annual / Periodical Audit:

It is also known as periodical audit. It is generally start after the completion aspect more than the depth aspect of audit.

**Final Audits have the following advantages**

1. **Inexpensive / Economical:** Since the audit spends normal time on the audit work, the audit fees are also normal. Final Audit is thus inexpensive. Even a small organization (a sole trader or a firm) can opt for a Final Audit to obtain the advantages of an independent financial audit.
2. **Audit at a Stretch**: Since the audit work is done at a stretch, without any gaps, audit is carried out efficiently. All queries are solved immediately. The work is done continuously and not in installments. The audit planning and programme are simple
3. **Less errors and Frauds**: Since the books are checked at a stretch, no employee can change any figures in the audited books.
4. **Do not Disrupt Accounts Work**: The accounts staff is not disturbed anytime during the accounting year. There is no need for the accountants to attend to audit work every now and then.

**Final Audit has the following disadvantages –**

1) **Delay in final Accounts**: Since the routine audit is done after a year end, the Final accounts may be delayed and ready long after the year end.
2) **Late Dividends to Shareholders**: The shareholders would be unhappy as they receive dividends long after the end of the financial year. It would be difficult for a Company to prepare interim accounts and pay interim dividends to the shareholders during the financial year.
3) **Stale Accounts for Banks/Investors**: The final accounts are available long after the end of the accounting year. Such stale accounts are not useful to banks and investors for taking decisions regarding loans and investment.
4) **No Moral check on Employees**: Since the auditors visit only at the end of the year, dishonest employee have a chance to commit frauds during the year and clean up the accounts just before the auditors arrive, e.g. teeming and lading.
5) **No Familiarity with Client's Business**: Since the audit spends little time at the client's place, he cannot become familiar with all the aspects of client's business. They may affect the quality of audit.
6) **Sample Check**: Since the auditor has to complete the audit in a short time, he has to resort to sample checking. The increases the risk of missing material items.
7) **Uneven Work-load for Audit Staff**: Audit staff is overworked immediately after year end and comparatively less busy at other times.

**Distinction between continuous and periodic audit:**

| Sl No. | Continuous audit | Periodic audit |
|---|---|---|
| 1 | It is done continuously throughout the year | It is done at the end of the year. |
| 2 | It is suitable for big firms | It is suitable for small businesses. |
| 3 | Detailed checking is possible | Detailed checking is not possible. |
| 4 | There will be moral check on the staff | There will not be any moral check on the staff. |
| 5 | Audited final accounts can be submitted just after the close ofd the financial year. | Not possible to do so. |
| 6 | It is expensive | It is less expensive |
| 7 | Figures can be altered after they are checked. | Figures cannot be altered. |
| 8 | Errors can be detected and rectified earley | This is not possible as the opportunities of fraud are more. |

### ➩ Interim Audit:

Interim Audit is an audit conducted in between the annual audits. It is conducted to find out the interim profit and know the financial position at the end of a part of the accounting year.

**When Interim Audit is conducted:**

Interim Audit is conducted in the following cases –

A. **Quarterly Results**: Public Limited Companies listed on the stock exchange has to declare their quarterly results. It is preferable, though not compulsory, to declare such results on the basis of interim audit.

B. **Interim Dividends**: Interim audit is also advisable when a company intends to pay interim dividends. Interim audit would ensure that there are enough profits to justify payment of interim dividends.

C. **Sale of Business**: In case of a sole partnership firm, interim audit becomes necessary on admission, retirement or death of a partner, dissolution of partnership, sale of a firm to a company, valuation of goodwill etc.

D. **Changes in Firm**: In case of a proprietor, interim audit may be conducted when the business is proposed to be sold, to fix the purchase consideration.

In case of a partnership firm, interim audit becomes necessary on admission, retirement or death of a partner, dissolution of partnership, sale of firm to a company, valuation of goodwill etc.

**Advantages Interim Audit**

Interim audit is similar to Continuous Audit and enjoys similar advantages:

a) **Quarterly Results**: A public limited company listed on the stock exchange can comply with the statutory provision of declaring quarterly results.

b) **Interim Dividends to Shareholders**: The shareholders would be happy as the Company can pay interim dividends to the shareholders.

c) **Quick Preparation of Final Accounts**: Since the interim audit is already done, the Final Accounts can be prepared immediately after the year end.

d) **Up-to-date Accounts for Banks/Investors**: The up-to-date interim accounts are useful to banks and investors for taking decisions regarding loans and investment.

e) **Check on employees**: Interim audit acts as check on the employees to keep the accounts ready and up-to-date.

f) **Prevents errors and frauds**: Checking by the auditors for the purpose of interim audit helps to detect and even prevent errors and frauds.

g) **Thorough Final audit**: The auditor has more time at his disposal at the time of final audit, which reduces the risk of missing any material items.

h) **Utilization of Audit staff**: audit staff can be utilized in a better manner. Interim audit is done when the audit staff is relatively free.

**Disadvantages and Precautions:**

A. **Expensive**: Since the auditor does two audits in one year, the audit fees are more to that extent. Interim Audit is thus expensive.

B. **Audit in Installments**: since the audit work is done at two stages (interim and final) and not at one go, audit may be inefficient. It is difficult at the time of final audit to take up the work precisely at the stage where it was left at the time of interim audit. To overcome this, audit should be well-planned. The work done up to end of the interim audit, relevant voucher numbers, totals, etc. should be carefully noted in the Audit Note book.

C. **Disrupts Accounts Work**: Interim audit disrupts the work of accounts staff. To avoid this advantage, the audit programme should be coordinated with the client to avoid disruption in routine accounts work. The client should appoint an employee especially to co-ordinate with and attend to the auditors.

## ⇨ Balance Sheet Audit:

Balance Sheet Audit is an American terms which means verification of the items appearing in the balance sheet. It includes verification and valuation of assets and liabilities appearing in Balance Sheet.

**Applicability:**

Balance sheet Audits are not conducted in all cases. Such Audits are conducted in case of very large organization banks, etc. in the following circumstances –

1) **The Internal Control System is very strong.** The controls have been developed and tested over the years. The controls are capable of detecting and preventing errors and frauds.
2) **The volume of transaction is so large** that an in-depth checking is impossible. A detailed vouch-and-post audit is not possible if the final accounts arte to be ready in time.
3) **The concern has its own internal audit department.** The statutory auditor, therefore, need no duplicate this work.
4) The accounts staff is highly qualified, the management is professional and accounts are computerized

## IV. FROM THE POINT OF OBJECT

**BASED ON OBJECT**

- Cost Audit
- Management Audit
- Internal Audit
- Social Audit

⇨ **Cost Audit:**

It is a type of audit which involves verification of cost records maintained by the organisation.

⇨ **Management Audit:**

Management audit involves examines of the plans, policies, procedure, method and strategies and evaluates the performance of management with a view to improve organizational effectiveness.

⇨ **Internal Audit:**

**Prof. Meigs:** Internal Auditing is a continuous, critical review of financial and other operating activities by a staff of auditors, functioning as full time salaried employees.

**SAP 7** issued by the Institute of Chartered Accountants of India (ICAI) defines Internal Audit as follows: Internal Audit is separate component of Internal Control established to determine whether other internal Controls are well designed and properly operated.

⇨ **Social Audit**

Social Audit is a recent development in the field of auditing. It is based on the modern concept of social responsibility of business. Social audit examines to what extent the business is discharging its social responsibilities. It examines the contribution of the concern to the society at large.

## V. OTHER TYPES

OTHER TYPES
- Occasional Audit
- Cash Audit
- Operational Audit

### ⇨ Occasional Audit:

This audit is carried out according to the occasional need of the business of the client. It is done at the specific desire of the owners of the business where the audit is legally not compulsory. The auditor will conduct the audit according to the terms and reference. His report will mention the terms of reference as per the letter he has received.

### ⇨ Cash Audit:

It is a partial audit and not a complete audit. In this type of audit, the auditor examines only the cash transactions. He examines cash receipts and cash payments. The receipts and payments may be capital or revenue in nature. Cash transactions are checked with the help of receipts and vouchers and other evidences.

### ⇨ Operational / Performance Audit:

Operational audit is conducted to see that the business operations are improved in future. Operational audit goes beyond financial audit. It is conducted for the following purposes:

- To improve the profitability.
- To guide the management in achievement of organisational objectives.
- To examine the efficiency of the management in conducting various operations.
- To evaluate the management policies and procedures.
- To advice the management on business operations.

## FACTORS TO BE CONSIDERED ON A NEW AUDIT:

The following are the important points to be considered by the auditor before commencing a new audit:

1) **To know about the scope of duties: -** the auditor should get written and detailed instructions from the client regarding the scope of work as in the case of sole proprietorship firms.

2) **Nature of the business: -** the auditor should make himself fully familiar with the basic nature of the business. In case, if the business is of technical nature, the auditor should be clear with the technical nature of the transactions. This knowledge will help the auditor to do the work efficiently.
3) **Knowledge about the accounting system: -** knowledge about the accounting system is very important for the smooth conduct of the audit. If it is repeat audit, the auditor should obtain the previous year's audited annual accounts, a complete list of all the books of accounts in use and auditor's report if any.
4) **Knowledge about the internal control and internal audit: -** the auditor should examine in detail, the system of internal check and internal audit if any, because only on the basis of the reliability and efficiency of these control measures the auditor can decide about the sample verification or detailed checking.
5) **Study of the important documents: -** the auditor should study the memorandum of association, articles of association , reports of directors and share holder's meetings, prospectus, the underwriting agreement etc., in case of a joint stock company. Similarly partnership deed and the trust deed will give the important information about the partnership firms and trusts.
6) **Organisational structure: -** the organisational structure of the business unit is to be studied in detail. The organisational chart is helpful to know about the authority and responsibility of deferent individuals.
7) **Information about the principal officials: -** the auditor should obtain the names and designations of the principal officers of the firm and if possible should meet them in person.
8) **Change of auditors: -** where an auditor so appointed in the place of another auditor, the new auditor so appointed has to enquire about the reasons as to the change of auditor.
9) **Previous year's audited balance sheet: -** the auditor should obtain the previous year's audited balance sheet if any and should see that the accounts during the current year have been opened with those balances that appeared in the previous balance sheet.
10) **To know about the policy of the board of directors: -** the auditor should try to be familiar with the policy of the board of directors in delegating the authority to the management and study the efficiency of the management in controlling the staff.

## PREPARATION BY THE AUDITOR BEFORE BEGINNING THE AUDIT WORK:

- Division of work
- Audit programme
- Audit files
- Audit note book
- Audit working papers

## DIVISION OF WORK:

The auditor cannot handle the entire work by himself, so the work is divided among his staff considering of senior and junior audit clerks.

## AUDIT PROGRAMME:

An audit programme is defined as "a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements, and giving the estimated time required'.

Hence an audit programme is a statement giving instructions and guidance to the audit staff as to the audit procedure. It arranges and distributes the work among the audit staff.

### Features of audit programme:

1. It is always in writing and drawn by the auditor.
2. It contains full details and procedures of the work to be conducted during audit.
3. It contains the distribution of work of the audit staff.
4. It states the responsibilities of the client's staff
5. It must be flexible.

### Types or methods of audit programme:

1. **Complete Programme: -** Complete programme is on the file. Completed items are ticked off by the particular assistant. Assistant knows what he has to do. He also knows that by which date each item is to be completed.
2. **Individual Programme: -** According to the nature of the business auditor prepares the programme for each assistant in such cases.
3. **No Any Advance Programme: -** In this case auditor never prepares the programme in advance but according the progress of the work he allows to go.

### Advantages of audit programme

1. **Supervision of Work:** - The auditor can judge the efficiency of his audit team by holding of an audit programme. He is in a position to know the progress of the work. He can see at any time that what part of the work has been completed and what remains to be done.
2. **Distribution of Work: -** Audit programme is very useful in distributing the audit work properly among the members f the audit team according to their talent.
3. **Uniformity of Work: -** Audit programme helps in settling all the things in advance, so the uniformity of work can be achieved.
4. **Basic Instrument for Training: -** Audit programme is very useful for the new auditor. It provides training and guidance to him. So it is rightly called the basic instrument for training.

5. **Legal Evidence: -** Audit programme is a legal evidence of work done by every assistant of the audit team. It can be presented in the court of law if any client is taken against the auditor for negligence.
6. **Fixation of Responsibility: -** If any error or fraud remains undetected the responsibility of negligence will fall on the particular assistant who has performed that job.
7. **Several Audits may be controlled: -** The auditor controls the audit of various companies at the same time. In the absence of audit programme he cannot supervise them effectively.
8. **Easy Transfer: -** If one assistant is unable to continue the work given to him, it can be given to another person. Audit programme guides him that what is done and what is remaining.
9. **Final Review: -** Before signing the report, final review is made and for this purpose also auditing programme is very useful.
10. **Useful for Future as a reference: -** On completion of an audit, it serves the purpose of audit record which may be useful for future reference.

**Disadvantages of audit programme**

1) **Not Comprehensive: -** Auditors may have covered the whole field but it cannot be said with certainty that all the necessary work have been done.
2) **Rigidness: -** Audit programme looses its flexibility. While each business has separate problems. So audit programme cannot be laid down for each type of business.
3) **No Initiative: -** It kills the initiative of capable persons assistant cannot suggest any improvement in the plan.
4) **Too Mechanical: -** Such audit programme is mechanical that it ignores many other aspects like internal control.
5) **Not Suitable for Small Audit: -** It has been proved that audit programme is not suitable for sail audits.
6) **New Problems over Looked: -** With the passage of time new problems arise which may be over looked.

**Steps to be taken for overcoming the disadvantages of audit programme:**

1. The audit staff should be made to understand that the audit program is only a guide, and they should use their initiative and intelligence in the course of their audit work.
2. The audit staff should be encouraged to make suggestions for the preparation of the audit programme, and their suggestions should be taken into consideration, while drafting the audit programme.
3. Great care must be taken to see that audit programme does not become stereotyped and mechanical.

4. It should be reviewed periodically, and revisions should be made in the audit programme in the light of the experience gained in the course of the audit.
5. Care should be taken to see that programme is an improvement over the previous year's audit programme.

An audit program to be serviceable must be elastic. Only it can enable the auditor to have proper control over the whole audit work and complete the audit work in time.

## AUDIT NOTE BOOK:

An audit note book is one of the most important documents maintained by the auditor. It is defined as a record used mainly in recording audit, containing data on work done and comments made.

Audit Note book contains information regarding the day to day work performed by the audit staff, notes about errors, explanations required etc. the auditor can use it as an authentic evidence in the court if there is any case against him.

### Contents of Audit Note Book:

1. Nature of business and important documents such as MOA, AOA, Partnership deed etc.
2. List of books of accounts.
3. List of officials, their duties and responsibilities.
4. Copy of the audit programme.
5. Information on missing receipts, vouchers etc.
6. Details of errors discovered.
7. Explanations sought from the officials.
8. Points to be included in the audit report.

An audit note book should be preserved by the auditor as it contains valuable information in respect of the work done by its staff.

### Special matters to be recorded in the audit note book

1. Routine queries not cleared, i.e., missing receipts and vouchers etc.
2. Details of mistakes and errors discovered.
3. The points raised during the course of audit, to which the attention of the auditor must be drawn, i.e. failure of the company to comply with the provisions of the Companies Act or of the Memorandum of Association and other legal requirements.
4. Extracts from minutes books and contracts and other correspondence with various government agencies, financial institutions, debtors, creditors etc.
5. The points to be incorporate in the audit report.
6. The points which needs further explanation and clarification e.g., a change in the basis of valuation of finished stocks or in the computation of depreciation, etc.
7. Date of commencement and completion of the audit.

## Objectives of audit note book

1. To know about the nature of business
2. Detection and prevention of frauds and errors effectively.
3. To make the future audit work easier.
4. To know the facts where clarification and explanation are essential.
5. To check the list of debtors and creditors.
6. To prevent as a proof by the auditor to clearance over the cases.

## Advantage of audit note book:

1. **Audit Report: -** The audit notebook is helpful to prepare audit report. The auditor can record the weakness of accounting records. The queries not properly answered are started in the audit report when the auditor is satisfied he can submit a clear report.
2. **Staff Honesty: -** The audit notebook is used to determine the integrity and honesty of audit clerks. The moral and ethical value can be examined through audit work. When a person completes his work in time. Time period auditor can appreciate him. If there is pending work after the expiry of time period, he can be held responsible for it. The audit staff must be honest in his work.
3. **Helpful for Memory: -** The audit notebook is help to keep things fresh in memory. The auditor can read the book on daily basis. He can note the weakness on fingertips. The auditor can retain the data in his memory for a longer period of time. He can ask the management to clear the doubtful points before preparing audit report.
4. **Reference: -** The audit notebook is useful for reference. In future it can provide information to the audit staff. The past data gives an insight into business matters. The auditor can note the changes. He can form an opinion about the changes in the nature and size of the business.
5. **New Auditor: -** The audit notebook is useful for new auditor. They can see the weakness of previous years. The old weak points may not be repeated this year.
6. **Court Cases: -** The audit notebook is helpful to defend an auditor in court cases. The people can go to court of law in order to fix liability for negligence of duty. The audit notebook is a written proof of work performed by an auditor.

## Disadvantage of audit note book.

1. It develops a fault finding attitude in the minds of audit staff.
2. It places too much reliance on the staff of the client for its preparation.
3. Very often, audit note book creates misunderstanding between the client's staff and the audit staff.
4. If prepared negligently, the auditor can use it as an evidence in the court of law.

## AUDIT WORKING PAPERS:

Audit working papers are those papers which contain essential facts about accounts, which are being audited. It's defined as the file of analysis, summaries, comments and correspondence build up by the auditor during the course of audit.

The institute of chartered accountants of India states that "an auditor is expected to maintain evidence of work done by him and his staff". The auditor maintains papers as supporting evidence to the audit work.

Arnold. W. Johnson defines audit working papers as "audit working papers are the written private materials which an auditor prepares for each audit. They describe the accounting information, which he has received from his client, the methods of examination used, his conclusions and financial statement".

### Contents of audit working papers:

1. The schedule of debtors, creditors, fixed assets, investments and liabilities.
2. Certificates regarding quality of stock in trade and its valuation.
3. Important extracts from the minute book.
4. Rough trial balance, trading and profit and loss account and balance sheet of concern.
5. Duly completed audit work programme with initials of the audit staff who have done that work.
6. Complete details of the quires and explanations obtained from the client's staff.

### Essentials or Advantages of good working papers

1) **Elements of completeness: -** working paper should be complete, consistent and accurate, covering all the significant and relevant data. Moreover it should be properly organsied and accurate in its presentation.
2) **Element of clarity: -** the working papers should clearly specify the type of verification and investigation procedures used to collect the information, so that even a person not familiar with the work may understand the same.
3) **Standardised form and good quality papers: -** the working paper should be Standardised form and good quality papers because it is subject to frequent handling.
4) **Space for remarks: -** there should be enough space in the working papers to write the name or initials of the person who have reviewed or cross checked the work and also to write the source from which the data is obtained.
5) **Proper filling: -** the working papers should be arranged according to various headings and sub-headings indicating the name of the department to which the data belong, and the data on which audit examination was carried out.

**Ownership of working papers:**

The auditor who collects information through working papers for his audit work. Usually claims that he is the owner of the working papers. On the other hand the company claims that the auditor was appointed by and he only acts as its agent. Hence, all the documents that the auditor had collected should belong to the company several cases have been referred to the courts regarding the ownership in one of the cases it was decided that the working papers belong to the auditor because he was an independent professional and not an agent of the client. In another case also, it was held that the working papers belong to the auditor.

**AUDIT FILES:**

An audit files is often engaged in a number of audits simultaneously, he usually keeps the record of each audit in a separate file for ready reference. Such a file is called audit file.

**Types of Audit Files:**

1. **Permanent file: -** it contains those working papers, which are useful for conducting the examination year after year. It contains information about client, which will not change from year to year.

   *It contains the following documents:*

   **a)** Client's name, address, telephone number etc.
   **b)** History and the nature of the client's business, place of business and its products.
   **c)** Constitution of the client's business.
   **d)** A list of important books and documents maintained by the business.
   **e)** A complete list of organization chart, work flowchart and the list of senior officials with their specimen signature.
   **f)** A copy of previous years audited final accounts along with the audit notes and auditors reports.
   **g)** Records of all documents or information of continuing importance.
   **h)** Special financial arrangements and other significant contracts.

2. **Current files: -** it contains only those details, which have a bearing on the current audit.

   *It contains the following documents:*

   **a)** A copy of the audit programme and audit tests performed.
   **b)** Queries raised during the audit and the relevant comments obtained.
   **c)** A copy of trail balance.
   **d)** A copy of final accounts under review.
   **e)** Bank reconciliation statements.

**f)** Certificate from client confirming stock valuation.
**g)** Tax, gratuity and bonus computation sheets.
**h)** A complete list of missing vouchers.

**Advantages of audit files:**

1) It helpful in the preparation of audit plan that is helpful for the subsequent audit engagements.
2) The auditor uses this file for forming an opinion about the matters to be included in the audit report.
3) It acts as a ready reference for the auditor and it supplies all the relevant information about the audit.
4) Audit file helps the auditor to give necessary information to the management.
5) It maximises efficiency in auditing procedures.

## TEST CHECKING OR SELECTIVE VERIFICATION

Test checking is sample checking. The whole data must not be examined. The audit staffs can statistical technique to check the facts and figures. A certain percentage of transaction can be selected for through examination. The remaining transactions are supposed as checked.

Definition

According to Professor Meigs, "*Test Checking means to select or examine a representative sample from a large number of similar items.*"

**Essentials of Test Checking**

1) **Sample: -** The sample items selected from whole data must be representative. The selection can be made by any method. The entire data must be presented in the form of sample.
2) **Last Month: -** The last month of the accounting year is most important. The items appearing in the last month must be given maximum importance at the time of selecting the sample.
3) **First Month: -** The first month of accounting year provides essentials information. The transactions recorded in the first month must be assigned high weight age in order to select the sample.
4) **Surprise Testing: -** The auditors include the element of surprise in selection of test. The accounting staff must be unaware of test checking so that he should not make arrangement for test checking.
5) **Checking Method: -** The auditor can change his method of selecting the sample. At one time he can one use alternate method. The selection method must be charged in time to time.

6) **Every Type of Transaction: -** The auditor must select every type of transaction in test checking. There is a need to include each type of dealing in the sample.
7) **Every Employee: -** The auditor can select the work of every employee. The test checking can be used to examine the work of all employees in the organisation.
8) **Throughout the Year: -** The test checking can be applied to all items appearing in the books throughout the year. The recurring items are most suitable for test checking.
9) **Cash Book: -** The cash book entries must not be used for test checking. There is a need of cent percent checking of all cash items appearing in cashbook. The control over cash is essential for efficient business working.

### Advantages of Test Checking

1) **Time saving: -** The benefit of test checking is available in the shape of time saving. A simple of items is checked and remaining items are treated as checked. In this way there is saving in time.
2) **Less Labour: -** The test checking is useful for saving in labour. A lot of work requires many clerks for completing the audit. But test checking is used to test few items so there is less labour work.
3) **Accurate Books: -** The test checking is useful to note the accuracy of accounting books and other record. There is a demand of error free books. The test checking is a step in the right direction to prove accuracy.
4) **Staff Efficiency: -** The efficiency of accounting staff improves due to test checking. The weakness of employee is reported to management. The employees try to improve their work by overcoming their deficiencies.
5) **Timely Report: -** The benefit of test checking is that timely report can be submitted to the management. The large number of figures can be checked in short period of time so there is no delay.
6) **Many Audits: -** Test Checking is useful to complete many audits in one year. It saves sufficient time, which can be used to check the books of new clients. The auditor is able to raise more income.
7) **Special Attention: -** The auditor can pay special attention to important matters. Test Checking reduces the labour work on the part of audit staff. There is sufficient time period to settle the important matters.

### Disadvantages of Test Checking

1) **Errors: -** The demerit of test checking is that errors are not disclosed by it. In the presence of error true and fair view is not possible. No doubt the location of errors is the duty of management but it effects the audit work.

2) **Frauds: -** The demerit of test checking is that planned frauds may not be disclosed. The fraud discovers is the responsibility of management. The audited accounts cannot show true and fair view when fraud exists in books.
3) **Responsibility: -** The demerit of test checking is that auditor cannot shift his responsibility of management. The errors of fraud can be discovered through cent percent checking. So auditor is responsible for test checking.
4) **Report: -** The auditor report may fail to disclose true and fair view of business matters. After test the auditor signs checking the auditor report. The auditor is responsible for audit report based on test checking.

## ROUTINE CHECKING:

Routine checking is the regular monitoring of business accounts, books and ledgers to determine how the business is functioning and to detect any errors that may have occurred, either accidentally or fraudulently.

### Essentials of Routine Checking

1. **Sub-Cast: -** Sub-Cast is a part of routine checking. Sub-total is possible in accounts matters. The sub-cast must be correct.
2. **Casts: -** Cast is part of routing checking. Total in journal and ledger accounts should be examined for accurate results.
3. Carry Forward: - Carry forward is a part of routing checking. The balance of one page can be transferred to the next page.
4. **Posting: -** Posting is a part of routing checking. The entries are posted in to the ledger accounts. Posting must be properly examined.
5. **Balancing: -** Balancing is a part of routing checking. Taking the difference of debit and credit in the accounts is called balancing.
6. **Carry Down: -** The amounts in an account can be transferred to next page. The carry down is a part of routing checking.
7. **Transfer: -** Transfer is part of routing checking. The amount is one accounts can be transferred to another account.

### Advantages of Routine Checking

1. **Accuracy: -** The benefit of routine checking is that there is accuracy of accounting books and records. The sub-total, casts and carry forward posting, balancing and transfer are stated as correct.
2. **Frauds: -** Routine checking is useful to checking fraud in the books of accounts. The responsibility lies on the head of management for location of fraud. The management can use this tool to meet its duty.

3. **Positive Verification: -** Routine checking helps to verify positive made in the ledger. The correct posting can provide true and fair view of financial statements. The management can verify posting through it.
4. **No Change in Figures: -** Routine checking is useful to eliminate the alternation of figures. The management can meet its obligation with the help of routine checking. The employees cannot alter figures.
5. **Final Checking: -** The benefit of routine checking is that final checking work is reduced. The final checking become early as major work has already been completed through routine checking.

**Disadvantages of Routine Checking**

1. **No Care: -** The work of routine checking is given to junior employee. They do not consider it as important matter. Therefore the expected result cannot be produced for audit purpose.
2. **Fraud: -** The demerit of routine checking is that planned frauds are not disclosed. The responsibility of fraud lies on head of management. The audited accounts may fail to provide true and fair view.
3. **Error: -** The demerit of routine checking is that errors of principle are not disclosed. The responsibility or error can be placed on the head of management. The audited accounts may fail to provide true and fair view.
4. **Monotony: -** The work is routine checking is boring and time consuming. The clerks go on checking the totals and sub-totals and balances. It does not improve the performance of employee rather it brings monetary.

**AUDIT IN DEPTH**

Audit in depth means the examination of the selected items in depth or in detail from the origin of the transactions to their conclusion.

Advantages of audit in dept

1) It gives the auditor an overall picture of the procedures that are being followed in the business.
2) It contributes to the success of test checking.
3) It exercises a moral check or pressure on the staff of the client.
4) It helps in detecting the well designed frauds.
5) It saves the time and energy of the auditor and enables him to devote more time and energy to more important matters.

# INTERNAL CONTROL

**Meaning of Internal Control:**

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

**Definition of Internal Control:**

The council of the institute of charted accounts of England and Wales defined as "the whole system of controls, financial and otherwise established by the management in the conduct of a business including internal check internal audit and other forms of control".

**Objective advantages of Internal Control:**

1. From the clients point of view.
   a. Internal control system provides authentic and reliable data useful to take business decisions.
   b. It safeguards the physical and non-physical assets in the form of records, documentation etc.
   c. It promotes operational efficiency, by preventing waste, duplication of work and inefficient use of resources.
   d. A good system of internal control provides that the company follows the procedures and rules as required by the law.
2. From auditors point of view.
   An auditor evaluates a system of control before commencing an audit work his work becomes easier if the control system is efficient. He can also decide whether detail verification is necessary or not.

**Elements / Features / Characteristics / Principles of a good Internal Control System:**

An effective internal control system should have the following factors:

1. **Competent and trust worthy staff:** people in charge of internal control system must be reliable and highly competent about the work. Lack of knowledge and dishonesty will spoil the efficiency of the system.
2. **Records of financial and other organizational plans:** A good internal control system must have good documentation system. Filing, recording, classifying, etc will help in this regard.
3. **Segregation of duties:** normally, there should be a separate department for internal control this reduces frauds, bias etc. normally; a clerk in charge of accounting function should not be in charge of assets also.

4. **Supervision:** proper reviewing of the operations of the company regularly makes the control system effective.
5. **Authorization:** all transactions must be properly authorized. In other words, the authority of each person should be well defined.
6. **Sound practices:** the company should have well established procedures, policies, delegations organizational manuals etc.
7. **Internal Audit:** it's a part of internal control and it should be independent of internal check.
8. **Accounting Controls:** proper accounting information systems should be established so that the information relating to accounts is properly collected, recorded and accounts prepared.

**Scope of Internal Control or Areas of Internal Control:**

1. **General financial Control:** It's concerned with control over all finance functions i.e., planning, acquiring and investing funds and management of profits. It deals with accounting supervision recording etc of the finance department.
2. **Cash Control:** it's concerned with proper control over receipts payments and balance of cash. The control system must ensure that misappropriation of cash is prevented.
3. **Control over wages:** this includes maintenance of time records, wage records, and payment to workers. The main area of concern in this regard is the check payment to wages for the work not done and misappropriations of cash.
4. **Control over purchases:** the system of internal control regarding purchases should be developed in such a manner that purchasing accounting, handling and issuing of goods are properly controlled.

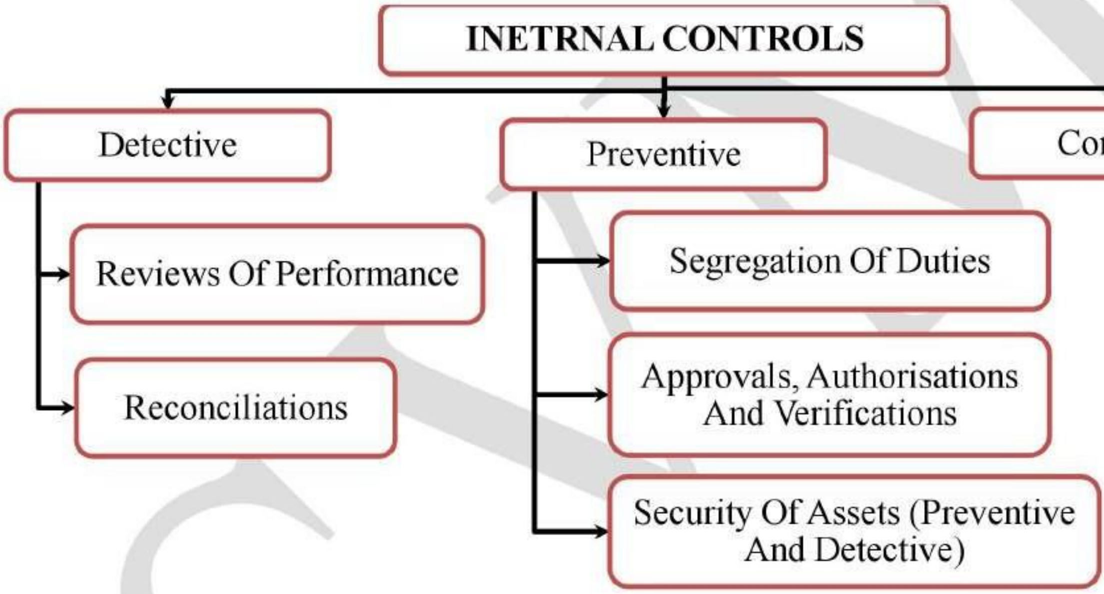
**Evaluation of the internal control system:**

The evaluation of the internal control system is done in the following manner:

1. **Determining the prevailing control mechanism in the organisation: -** First, the auditor should enquire about the accounting system of the enterprise. This information is to be verified with the personnel involved with the system through discussions. This is the method of finding out whether the internal control system installed by the management is being followed or not.
2. **Close examination of the transactions: -** The second step is close examination of few transactions so as to confirm the correctness of the procedures and controls imposed at various stages. It is important to note that the transactions so studied should be checked from the beginning to the end. The staff involved with that work should also be questioned at every stage.

3. **Evaluation: -** At this stage, in order to gather the exact information, an internal control questionnaire or a flow-chart is to evaluate the system in detail.
4. **Confirming the evaluation: -** at this stage, the auditor is in a position to point out the strong and weak points of the internal control system.
5. **Recommendation for improvement: -** After finding out the merits and demerits of the internal control system, the auditor should inform the management if it is it is effective, if not suggestions should be made or recommended for improvement of the system.
6. **Follow up: -** the last step is the follow up. That is the auditor should check whether his recommendations are implemented by the subsequent review of the system.

**Types of internal control:**




## I. DETECTIVE

Detective controls are designed to find errors or irregularities after they have occurred. Examples of detective controls are:

i. **Review of performance: -** Management compares information about current performance to budgets, forecasts, prior periods or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unusual conditions that require follow-up.

ii. **Reconciliations: -** An employee relates different sets of data to one another, identifies and investigates differences and takes corrective actions, when necessary.

## II. PREVENTIVE

Preventive controls are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure departmental objectives are being met.

i. **Segregation of duties: -** duties are segregated among different people to reduce the risk of error or inappropriate action. Normally, responsibilities for authorizing transactions (approval), recording transactions (accounting) and handling the related asset (custody) are divided.

ii. **Approvals, authorization and verifications: -** Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.

iii. **Securities of assets (preventive and detective): -** Access to equipment, inventories, securities, cash and other assets is restricted; assets are periodically counted and compared to amounts shown on control records.

## III. CORRECTIVE

**Corrective controls** are internal controls developed to remedy errors that can be systematically corrected. At time this may also involve additional training or employee disciplinary action. Following discovery of major fraud, corrective controls are developed to counter the particular scheme employed by the perpetrator.

**Disadvantages of Internal Control:**

1. It involves expenditure which may not be affordable by the small organizations.
2. Internal control is concerned with routine transactions many times unusual transactions may be over looked.
3. The system of internal control may be weakened due to inefficiency in handling of the system.
4. There are chances of diverse objectives among employees in the departments and staff in charge of internal control.
5. Management may manipulate the operation of internal control system.

## INTERNAL CHECK:

The term internal check implies that the work of various members of the staff is allocated in such a way that the work done by one person is automatically checked by another.

According to L.R.Dicksee, defined as "such an arrangement of book keeping routine where in errors and frauds are likely to be prevented or discovered by the very occupation of book keeping itself".

**Objectives of internal check:**

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

**Fundamental principles or Points to be considered in framing a Good Internal Check:**

1. No single employee should have independent control over any important aspect of the business. In other words the work of employed should be automatically received by another.
2. The duties of the employees should be changed from time to time without prior notice.
3. Employees who control physical assets should not have assets to goods of account.
4. It's better to follow a system of self balancing ledger.
5. Account must be periodically verified.
6. The allocation of work must be carefully done and the position must be reviewed periodically.
7. While stock taking the pricing and evaluation of stock should be done by the people who are not connected to stores department.
8. A cashier should not be in charge of maintaining accounts complete bank transactions etc.

**Advantages of internal check:**

1) **Proper allocation of work: -** it facilitates a proper and rational distribution of work among the members of the staff based on the principles of division of labour.
2) **Early detection and minimisation of errors and frauds: -** in an internal check system no individual is allowed-to handle a job completely from beginning to the end the work of each individual is automatically checked by the other. This arrangement helps in the early detection of errors and frauds and the possibilities of their commission are minimised.
3) **Increased efficiency: -** in an internal cheek system, there is a proper and rational distribution of work among the employee according to their qualification, experience and specialization. It leads to increased efficiency of work and overall economy.
4) **Quick preparation of final accounts: -** in an internal check system all accounts are checked side by side, no errors remain in the book keeping, hence, final accounts can be prepared easily and without any loss of time.

5) **Convenience to the auditor: -** in an organization where, internal check system is prevalent, routine checking is not required. Possibilities of error and frauds are minimum. The statutory auditor can easily avoid detailed checking and adopt only test checking. His work, thus becomes very easy.
6) **Increase in the profit and development of the business: -** internal check system leads to overall efficiency and economy in operations, which in turns results in more profits to the share holders and development of the business.
7) **Reliable accounting system: -** if there is a good system of internal check, the owner of the concern may rely upon the geniuses and accuracy of the accounts.

**Limitations of internal check:**

1) **Expensive for small business: -** internal check system requires a large number of employees so it is quite expensive especially for small business.
2) **Collusion among employees: -** in an internal check system there are possibilities of collusion among employees. As a result, frauds may happen.
3) **Disorder in the working of the business: -** in the absence of a well organized internal check system creates mutual rivalries among employees.
4) **Quality sacrificed: -** every employee of the business wants to complete the work quickly without taking it seriously. As a result possibility of error remains and quality suffers.
5) **Carelessness on the part of the audit: -** the auditor comes to rely on the correctness of accounts. He may not apply test and procedures of his own. So his work suffers. Some of the irregularities may remain undetected.
6) **Risky for an auditor: -** if the auditor does not apply tests and procedures of his own and if he relies on the output of the system his work cannot be free from irregularities.

**Internal check and the Auditor:**

The auditor before starting audit work evaluates the system of internal check. If it is efficient he may avoid detailed checking of the transactions and he can carry out a few test check of the transactions to what extent should an auditor rely upon the system of internal check will depend upon the degree of effectiveness with which, the system is followed as well as the size of the business. If the internal check system is inefficient, he had to check in detail all transactions. It should be remembered that even if the internal check system is efficient he should still test its existence and efficiency.

Efficient internal check system reduces his work but not his responsibility. If in the process of examination of accounts if he finds any weakness in his system, he should report it to his client. Thus the existence of a good internal check system may help an auditor to a great extent, but does not reduce his legal liability. If any fraud is discovered subsequently he may be held quietly of negligence. He can't defend himself saying that he relied upon the efficient internal check system that existed in the business.

**Internal check regarding CASH SALES:**

In big business houses, where daily transactions of cash sales are larger in number, there are many chances of fraud and irregularities. In such cases, a good system of internal check is very helpful to find out frauds and errors. Usually cash sales may take three forms.

1. Sales at counter
2. Sales by travelling agents, and
3. Postal sales

❖ **Sales over the counter.**

The following is the internal check system regarding sales over the counter.

1. Each counter should have a separate salesman.
2. Each salesman should be given a separate sales memo book. Usually different color is used for different counters,
3. Sales memo should be prepared by the salesman in 4 copies.
4. The sales memo is checked by another clerk before being handed it over to customer. A copy is retained by the clerk.
5. Payment is made at the cash counter.
6. One copy of cash memo is returned to the internal duly stamped as cash paid 2 copies are returning the cashier.
7. The cashier records days total sales in cash sales register.
8. Every salesman should prepare total sales summary of the respective counters. At the end of the day total sales as recorded by salesman, total cash received and total sales as per register must agree with each other.

❖ **Postal Sales:**

The following is the internal check system regarding Postal Sales

1. A separate register should be maintained to record details of postal sales.
2. Cash may be received either with order or at the time of delivery.
3. Proper records will be made in this regard for cash received and due.
4. Usually, goods are sent by VPP (value payable post).
5. The sales register must be checked in detail by a senior officer.

❖ **Sales by Traveling Agents:**

The following is the internal check system regarding Sales by Traveling Agents

1. Traveling salesman should not be allowed to issue final receipts to customers.
2. Amount received must be remitted to H.O. account on daily basis.
3. Salesman should not be allowed to deduct their expenses or commission from the sale proceeds.
4. The salesman should submit periodical sales report which must be examined in detail.

**Internal check regarding WAGES:**

In a large organization, expenses on wages with form one of the major portions of expenses. The chances of frauds are also high in this regard. In this background, a good system of internal check assumes significance.

a. Frauds might be in the form of recording more wages than actually paid.
b. Payment of wages to dummy/ghost workers.
c. Recording wages for which no payment has been made etc.

The design of internal check system should try to prevent the above fraud. The following internal check system is suggested in this regard.

1. **Maintaining Time Records:** A department is in charge of recording the time spent by the workers should be constituted as far as possible. Manual system of time keeping must be avoided. This brings down the fraud regarding the payment of wages for which no work is done.

   The time keeping check and the foremen should separately prepare the time recorded sheet recording the name of the worker, time of entry, names of absentees etc.

   In case if the workers are paid on piece rate system proper system of time booking must be followed each worker should be given a job and counter assigned by the supervisor.

   In case if workers work overtime, the overtime slips must be issued which is authorized by the concerned official. No worker should be allowed to work Over Time if he is not authorized to do so.

2. **Preparation of Wage Sheets:** Large scale organizations should evolve in an internal check system in such a manner that the chances of over payment, under payment, wrong payment to workers are minimized and prevented. Preparation of wage sheets should be the responsibility of a separate department. Separate wage sheets should be maintained for workers under time rate system and price rate system.

   The wage sheet should contain the following details:

   1) Name of the employee
   2) Number allotted and the address of the employee
   3) Number of hours worked
   4) Details of work
   5) Rate of work
   6) Total amount of wages
   7) Bonus, gratuity, house rent allowances if any
   8) Overtime wages if any
   9) Deductions, that is, income tax, provident fund, life insurance premium etc.
   10) Net amount payable.

*The preparation of wage sheets is usually done by five clerks. The distribution of work is mentioned below:*

- ✓ Two clerks should examine the time and price wage records. Over time records etc
- ✓ Another clerk should be in charge of preparing wage sheets of individual works.
- ✓ The 4th clerk checks the calculations deduct amount for PF, IT, etc to arrive at net amount to be paid to workers.
- ✓ Fifth clerk checks the whole work thoroughly.

All officials involved in the process, should sign the statements which will be approved by the work manager/ the production manager.

3. **Payment of Wages:**

A person is not involved either in maintaining time records preparation of wage sheets should be in charge of payment of wages. Usually the cashier in the accounts department will allot the wages, according to the information given by the wage sheet.

- ✓ As far as possible wages should be distributed personally to the workers who sign the Wage Register.
- ✓ Absentee workers should be paid through others workers only after written authorization is received.
- ✓ A list of unpaid wages should be prepared after the distribution of wages.
- ✓ If there are casual workers, payment should be made to them separately on a different day.

**Internal Check as Regards PURCHASE**

The purchase dept will be responsible for proper control over purchases as far as possible. Purchases must be centralised for the purpose of internal check. The purchase process may be divided as:

1. Purchase of materials.
2. Storage of goods or materials.
3. Issues of Materials.

1. **Purchase of Materials:**

- ✓ The concerned dept, head will send requisition letter to the purchase dept,
- ✓ For each dept, a separate file must be maintained for requisitions. Based on the requisition the purchase committee,
- ✓ Purchase dept, calls for tenders from approved suppliers.
- ✓ These tenders must be opened by the purchase committee and the least bidder will be chosen.

- ✓ Purchase order has to be sent to the selected suppliers. Usually, purchase order will be prepared by the purchase dept, a copy of which will be sent to the supplier, second to the stores, third to the accounting dept, and the fourth is retained by the purchase dept.
- ✓ When goods are received the stores keeper inspects them and compared with the purchase order.
- ✓ If goods are acceptable he enters them in goods inward book and issues the acceptance letter.
- ✓ A copy of the acceptance letter will go to the accounts dept, which will again compare goods approved letter with the purchase order.
- ✓ The accounts manager if satisfied authorizes for its payment.

2. **Storage of Goods:** The stores keeper should maintain proper records, regarding storage of goods. He usually maintains bin cards and stores ledger surprise.
3. **Issue of Materials:** Materials should always be issued against material requisition note. After each issue, and purchase proper record must be made in bin cards and stores ledger.

**Internal check as Regards Departmental Store:**

A department store is a large scale retail organisation working on self service basis selling the daily requirements of the customers. These are centrally located and attract customers.

**Operation of Department Stores:**

As the name itself suggests a dept., store is divided into many small departments, each department offering a specific product line. These depts. are headed by supervisors assisted by stock assistants. While the accounting departments, takes care of recording all transactions, in the cash dept, will be in charge of receipts and payments of cash. As it operates on self service basis cash is paid by the customer at the counter.

**Internal Check as regards Purchase:**

Goods are to be purchased as per the order of the G.M. The General Manager prepares purchase order based on the requisition notes sent by the supervisor. No supervisor should be given independent charge of purchase. A copy of the purchase order is sent to the accounting department and stores dept., when once the goods are received the store keeper verifies them with the order and approves for payment. The accounts department makes the payments after verifying the Purchase order and goods.

**Internal Check regarding Cash Receipts:**

Usually the cash counters are computerized which brings down the human errors. The customers make the payments directly at the counter. The counter clerk prepares the bill and receives the cash. Chances of error and fraud are less as goods are coded and price is mentioned against codes.

As far as petty cash expenses are concerned, the cashier should be in charge of petty cash expenses, which are recorded on daily basis. The goods are delivered after verifying the bill.

## INTERNAL AUDIT / OPERATIONS AUDIT:

Large scale organizations usually develop a system to review their activities to identify areas of non performances. Internal audit is a tool used in this regard.

### Definition internal audit:

Internal auditing involves a continuous critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees.

### Objective of Internal Audit:

1. To comment of the effectiveness of the internal control system in force and means of improving it.
1. To verify correctness accuracy and authenticity of the records presented to management.
2. To facilitate early detection of errors and frauds.
3. To ensure that standard accounting practices are followed.
4. To ensure that assets are properly acquired, safeguarded and accounted for.
5. To investigate in the areas as requested by the management.
6. To see that exhibited liabilities are valid.

### Advantages of Internal Audit:

1. Internal Audit makes the system of internal control more effective and efficient.
2. It makes the auditor's work more simple.
3. Errors and Frauds are detected early.
4. It increases the morale of the employees.
5. Employees will be more careful as their work will be audited immediately.

## Disadvantages of Internal Audit:

1. Small organizations cannot afford to have internal audit system as it's expensive.
2. The regular work of the organisation will be affected.
3. Internal auditor acts as a staff manager hence there are chances of differences of opinion between the internal auditor and the employees of the company.

## Difference between Internal and Independent Audit:

| Sl No. | Internal audit | External / Independent audit. |
|---|---|---|
| 1 | An internal auditor is a regular employee of the company. | He is a professional auditor appointed by the company who is not an employee. |
| 2 | His duties, rights and responsibilities are determined by management. | The scope of audit work liabilities, duties etc are explained by concerned statutes. |
| 3 | He is appointed by the management. | He is appointed either by shareholders or by govt., |
| 4 | It's not compulsory. | It is compulsory for all companies. |
| 5 | Internal auditor acts as an advisor to the management. | He is independent of the management. |
| 6 | To become an internal auditor professional qualification is not necessary. | An independent auditor must have professional qualification as per the act. |
| 7 | Internal Auditor ensures that the system of accounting is efficient. | The internal auditor comment on the true and fair view of business. |
| 8 | An internal auditor reports to the management. | The Internal Auditor reports to the shareholders. |
| 9 | Internal audit is a continuous process. | It's a periodic process. |

To conclude, it can be said that "the internal auditor's responsibility is to the management and he is not a servant of the independent auditor. His scope will be decided by the management and he should be free to communicate to the external auditor but should not involve himself with the work of independent auditor.

## Difference between internal checks and internal audit:

| Sl No. | 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. | It is independent appraisal of operation and records of the company. |

| | | |
|---|---|---|
| 2 | The purpose of Internal Check is to prevent minimise possibilities of errors and frauds. | The purpose is to detect errors and frauds that are already committed. |
| 3 | Internal Check doesn't require separate staff. It represents only the arrangement of duties. | It requires separate staff employed only for this purpose. |
| 4 | Internal Check is a continuous process. | The Internal auditor has to report periodically about various inefficiencies and suggest improvements. |
| 5 | Internal Check begins along with the recording of transactions. | It begins when the accounting process ends. |
| 6 | It is devices of doing the work. | It is a device for monitoring the work. |
| 7 | Scope of Internal Check is limited especially to the accounting department. | The scope of internal audit goes on beyond accounting department. |