AUDITING

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Himalaya Publishing House
ISO 9001:2008 CERTIFIED
AUDITING

(As per the Syllabus 2014-15 of Mumbai University for T. Y. BBI, Semester V)

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PREFACE

It is a matter of great pleasure to present the first edition of this book on AUDITING to the students and teachers of Third Year Bachelor of Commerce – Banking and Insurance (T.Y. BBI), Semester V course started by University of Mumbai.

We have tried to make and present the book in simple language and precise. We are hoping that the diagrams and step-by-step answers put up will be helpful to understand the subject clearly.

We are thankful to our all family members for constant support and motivation. We are also grateful to our Principal, Vice-Principal, Co-ordinator, Colleagues, Library Staff and my dear students and friends for encouraging us to write the book. Special thanks to Himalaya Publishing House Pvt. Ltd. for publishing our book.

Any constructive suggestions from the students and teachers for improving the text in future are welcome.

Authors
SYLLABUS

Unit – I  
**Introduction:** Meaning, Objects, Basic Principles and Techniques. Classification of Audit, Audit Planning, Internal Control, Internal Check and Internal Audit, Audit Procedure – Vouching and Verification of Assets & Liabilities. Special Areas of Audit; Special features of Cost audit and Management audit. Recent Trends in Auditing: Basic considerations of audit in EDP Environment.

Unit – II  
Audit of Limited Companies
- Qualification, Disqualification, Appointment, Removal, Remuneration of Auditors.
- Audit Ceiling-Status, Power, Duties and Liabilities of auditors.
- Branch Audit-Joint Audit-Special Audit.
- Divisible Profit, Dividend and Depreciation (Companies Act, Standards on Accounting, Legal Decisions and Auditor’s Responsibility.
- Representations by Management – Contents of Annual Report (A Brief Idea)

Unit – III  
Audit of Banks and Insurance Companies
- Insurance Companies- Legislation Relevant to Audit of Insurance companies (Life and general Insurance), Review of Internal Control, Audit Report (Matters as per IRDA).
- Role of regulatory authorities like Department of Company Affairs, SEBI, RBI, IRDA and Comptroller auditor General of India.

Unit – IV  
Other Trust Areas
- Systems Audit – Social Audit- Environment audit.
- Energy Audit – Forensic Audit – Peer review (Concepts, Objectives and Regulatory Requirement).
- Ethics in Auditing- Auditor’s Independence.
- Auditing in CIS Environment.
- Standards on Auditing (Concepts, Purpose and Present Position as to Number and Title as issued by ICAI).
- Role of Auditor vis. Audit Committees & corporate Governance principles.
Paper Pattern

Credit Based Grading System Scheme of Examination

- **Internal Assessment** 25 Marks
- **Semester End Examinations** 75 Marks

**Question Paper Pattern**

Q.1 (a) – 8 marks FOB/MCQ
(b) – 7 marks T/F/MCQ

Q.2 (a) – 8 marks
(b) – 7 marks

or

Q.2 (a) – 8 marks
(b) – 7 marks

Q.3 (a) – 8 marks
(b) – 7 marks

or

Q.3 (a) – 8 marks
(b) – 7 marks

Q.4 (a) – 8 marks
(b) – 7 marks

or

Q.4 (a) – 8 marks
(b) – 7 marks

Q.5 (a) – 8 marks
(b) – 7 marks

or

Q.5 (a) – 8 marks
(b) – 7 marks
1. Introduction to Auditing 1 – 11

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8. Role of Ethics and Regulation in Auditing Profession 98 – 103
1.1 MEANING AND DEFINITION OF AUDITING

The term audit is derived from the Latin word ‘Audire’, which means to hear. The original object of Auditing was to detect and prevent errors and frauds. In India, Company’s Act 1913 made audit of company accounts compulsory. Auditing is concerned with verification of accounting data, examination of all books of accounts, vouchers and other documents.

According to L. R. Dicksee

“Audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transaction to which they relate”.

According to A. W. Hanson

“An audit is an examination of such records to establish their reliability and the reliability of statements drawn from them”.

Objectives of Auditing
1. Primary Objectives
2. Secondary Objectives

1.2 PRIMARY OBJECTIVES

The Primary objective of auditing is to report whether the Balance Sheet and the Profit and Loss Account presents a true and fair view of the profit and loss for the financial period. Section 227 of the Companies Act, 1956, gives the objective of auditing. For this purpose, it is the duty of the auditor to examine the books of accounts and other records and to verify all evidence in support of all the transaction entered into the books of accounts. This examination helps the auditor in forming an opinion about the correctness and the reliability of the financial statements. Audit cannot be said complete unless the auditor gives his report on the accounts examined by him.
1.3 SECONDARY OBJECTIVES

Principles and Techniques of Auditing

1.3.1 Principles of Auditing

In auditing principle is the fundamental truth necessary for the fulfillment of auditing objectives. The Institute of Chartered Accountant of India has laid down the basic principles which govern an audit.

Following are the basic principles of Auditing:

1. **Principle of independence**: The auditor should be straight, honest and sincere in his approach to his professional work. If the principle of independence is not respected the objectives of auditing cannot be achieved.

2. **Principle of Objectivity**: Auditing should be conducted objectively. The auditor should be free from bias and emotions while conducting audit. It demands verification of the transaction and the use of reasonable skill.

3. **Principle of Confidentiality**: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority unless there is a legal or professional duty to disclose.

4. **Principle of Full Disclosure**: This principle implies that the client should provide to the auditor all the possible evidence, explanations and records. The auditor should make full disclosure of his findings.

5. **Principle of Materiality**: According to this principle, the auditor should pay more attention to the items that are more significant. Whether the items are materials or not, should be decided according to the situations.

6. **Skill and Competence**: The auditor should have adequate training, experience and competence in auditing. He must be aware of recent developments in the field of auditing such as statements of ICAI, changes in company law etc.

7. **Work Done by Others**: The auditor should direct, supervise and review the work done by his assistants. The work done by others must be up to the satisfaction of auditor.

8. **Working Papers**: The auditor should maintain working papers of important matters to prove that audit was conducted with due care according to the basic principles.

9. **Audit Evidence**: The report of the auditor should be based on evidence obtained in course of audit. Evidence may be obtained through vouching and verification.

10. **Planning**: The auditor should plan his audit work. He should prepare an Audit Programme to complete the audit efficiently and in time.

11. **Evaluation of Accounting System and Internal Control**: The auditor should ensure that the accounting system is adequate. He should evaluate the Internal Controls.
12. **Opinion and Report:** The auditor should arrive at his opinion on the accounts based on the audit, evidence and submit his report to the shareholder.

### 1.3.2 Techniques/Methods of Auditing

Audit techniques means the methods used to obtain audit evidence. There are various techniques of audit. Selection of a proper technique depends on the type of proposition to be reviewed and also on the nature of evidence available in support of the proposition.

Important techniques of auditing given by SAP 5 are as follows:

1. **Inspection of Documents:** Inspection consists of examination of records, documents and tangible assets. Examination of documents is one of the most important techniques of auditing.
   
   The auditor with reference to authenticity, appropriateness, authorization, and proper recording examines documents. Authenticity implies genuineness of the transaction. Appropriateness implies that the transaction is legitimate. Authorization means there proper approval for the transaction.
   
   There need not be inspection of all documents. Important documents can be checked on test check basis. The documents for inspection must be relevant.

2. **Observation:** It implies witnessing is a process or procedure performed by others. For e.g. the auditor may observe stock taking done by the staff.

3. **Inquiry:** Inquiry consists of seeking information from others. He may ask oral questions or he can also prepare a questionnaire.

4. **Confirmation:** Confirmation consists of response to an enquiry. For e.g. the organization may get confirmation from debtors and creditors.

5. **Computation:** It refers to checking the arithmetical accuracy of the transaction recorded in the books of accounts.

6. **Analytical Review:** It implies studying important ratios and trends and investigating into the unusual fluctuations. During the course of audit the auditor can scan various unusual transactions and examine them thoroughly.

### 1.4 AUDIT PLANNING ITS NEED AND OBJECTIVES

#### 1.4.1 Audit Planning

Audit planning is the process of preparing for the audit. It is organizing the conduct of audit. It is preparation of plan of action for the conduct of audit. Planning of audit enables the auditor to conduct an effective audit in an efficient and timely manner. Audit Planning covers the following:-

1. Determining the scope and purpose of audit.

2. Determining the audit programme required for the conduct of audit.
3. Understanding the accounting system and internal control system existing in the organization.
4. Dividing audit work among the audit staff.
5. Checking the work completion at every stage.
7. Reporting.

The above plan contents should form part of Audit working papers. It should contain a Time Budget for each audit area or audit procedure. It should be modified from time to time on the basis of actual audit work.

Based on the above overall audit plan, auditor should develop an audit programme showing who is to do what, when and how.

1.4.2. Objectives of Audit Planning

Audit planning has following objectives/advantages:

1. Adequate planning facilitates the direction and supervision of team members and review of their work.
2. Planning helps the auditor to identify and resolve potential problems on timely basis.
3. Planning assist in co-ordination of work by auditors of companies and experts.
4. Planning helps the auditor to devote appropriate attention to important areas of audit.
5. Planning helps the auditor to properly organise and manage the audit.
6. Planning helps in selection of team members with appropriate levels of capabilities and competence.

1.5 INTERNAL CONTROL, INTERNAL AUDIT, INTERNAL CHECK

1.5.1 Meaning and Definition of Internal Control

Internal Control means the procedures and measures adopted within a business to safeguard its assets. Check the accuracy and reliability of accounting data and promote operational efficiency.

AAS 6 issued by the Institute of Chartered Accountants of India (ICAI) defines Internal Controls as “The plan of the organization and all the methods and procedures adopted by the management of a concern to ensure the orderly and efficient conduct of its business”.

Thus, the internal control is a whole system of controls established by the management. It includes internal check and internal audit.

1.5.2 Objectives of Internal Control

Controls are divided into two parts Accounting Controls and Operational/Administrative Controls. The objectives of Internal controls are as follows:-
Introduction to Auditing

1. Accounting Controls
   (a) Prevention of errors and frauds.
   (b) Detection of errors and frauds.
   (c) Efficient use of Assets.
   (d) Proper policies laid down by management.
   (d) Helping to management in planning.

2. Administrative/Operational Controls
   Operational Controls aim to ensure that the management policies in respect of the operations of the concern are implemented, which in turn ensures that the business is conducted in an orderly and efficient manner.
   
   Examples
   (a) Proper Internal check.
   (b) Budgetary control.
   (c) Quality control.
   (d) Qualitative control.

1.5.3 Meaning and Definition of Internal Audit

Internal Audit is a part of internal control. It is an important tool of management. Its scope may vary depending on the nature and size of the organization.

According to 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”.

14.3.1 Features of Internal Audit

1. It is a part of the system of Internal Audit.
2. It is a critical review of other Internal Audit.
3. It is a kind of Continuous Audit
4. Usual audit techniques are followed for Internal Audit

1.6 MEANING AND DEFINITION OF INTERNAL CHECK

Internal Check is an integral part of internal control system Internal Check can be defined as “An arrangement of the duties of the members of staff in such a manner that the work performed by one person is automatically and independently checked by another person without a duplication of work”

1.6.1 Features of Internal Check

1. It is a part of the system of Internal Control.
2. It is the system of allocation of responsibility and division of work.
3. It aims to detect and prevent errors and frauds.
4. A single employee deals with only one aspect and not the entire transaction. The work is divided in such a way that no employee has an exclusive control over the transaction.

1.7 AUDIT PROCEDURE

Audit Procedure involves audit planning which is the basic principle that the auditor should plan his work to enable him to conduct an effective audit in an efficient manner. Adequate audit planning facilitates:

1. Devotion of appropriate attention to important areas of the audit.
2. Prompt identification of potential problems
3. Expeditors completion of work
4. Proper utilization of assistants, and
5. Coordination of work done by other auditors and experts.

1.8 OBJECTIVES QUESTION

1.8.1 State with reason whether the following statements are true or false.

1. Preparation of financial statements is the primary responsibility of the management.
2. Auditor must examine all the transactions.
3. An auditor cannot take the help of experts.
4. Statutory audit is voluntary.
5. Periodic audit dislocates the work of the organization.
6. Continuous audit dislocates the working of an organization.
7. Interim audit is compulsory for company.
8. Tax audit is done to assess correctness of taxable profit.
9. Efficiency auditor is a part of performance audit.
10. Audit in depth is part of test checking.
11. Audit programme must be in writing.
12. Audit note book is maintained by an auditor.
13. Test checking is mechanical.
14. SA 530 deals with audit sampling.
15. Tests check can be applied in homogeneous transactions.
16. Same person should be given the entire work of the transaction in order to avoid frauds.
17. Internal control has a narrow scope.
1.8.2 Fill in the blanks with appropriate word.

1. There is no chance of alteration of figures in ________.
2. The objective of ________ is to suggest improvement to the functions of the organization.
3. Cash audit is a ________ audit.
4. Under section ________ of the companies Act, 1956 the Central Government has power to appoint special auditor.
5. Book Keeping starts when business transactions ________.
6. A Book keeper is an ________ of an organization.
7. Investigation is ________ in scope.
8. Financial statements include ________ and ________.
9. Audit programme must be in ________.
10. Written Audit plan is called as ________.
11. The purpose of audit planning is devotes attention to important ________ of audit.
12. Internal control includes internal ________ and internal ________.
13. Routine checking is highly ________ process.
14. ________ are issued when goods are returned by customers.
15. ________ is a separate component of Internal control.

1.8.3 Select the correct alternatives.

1. Audit sampling is
   (a) Application of audit procedure for less than 100% transactions.
   (b) Verification of all the transactions
   (c) Verification of cash transactions.
   (d) Verification of goods distributed as free sample.
2. Size of the sample depends on
   (a) Internal control system
   (b) Test checking
   (c) Routine checking
   (d) Balance sheet audit
3. Good internal control system
   (a) Effective managerial suppression and review
   (b) Ineffective control
(c) Incompetent people
(d) Competent auditor

4. Independent auditor is a
(a) Watchdog for outsiders
(b) Watchdog for shareholders
(c) Watchdog for employee
(d) Watchdog for directors.

5. Routine checking involves checking of
(a) Castings
(b) Ledger
(c) Trial Balance
(d) Preparation of journal

6. An auditor is a watch dog and not a blood hound. This decision is given in
(a) Kingston cotton mills Case
(b) West Ministers road construction case
(c) Caparo Case
(d) Lalji Case

7. A per AAS4 if the auditor detects an error then
(a) He should inform the management
(b) He should communicate it to the management if it is material
(c) The auditor should ensure financial statements are adjusted for detected errors
(d) Both (b) and (c)

8. Misappropriation of goods is conducted by
(a) Auditors
(b) Employees
(c) Management
(d) All of the above

9. Special audit can be ordered by
(a) Central Government
(b) State Government
(c) Municipality
(d) Gram panchayat
10. In India Balance sheet audit is synonymous for
   (a) Annual audit
   (b) Continuous audit
   (c) Detailed audit
   (d) Statutory audit

11. The standard deals with audit planning
   (a) AAS7
   (b) AAS8
   (c) AAS9
   (d) AAS3

12. Objective of audit planning is
   (a) Identification of potential problems
   (b) Inefficient work
   (c) Deadline of work
   (d) None of the above

13. Setting up of materiality level
   (a) Controls the materials
   (b) Diverts the attention of the auditor to error prone items
   (c) Controls the audit assistants
   (d) None of the above

14. Stratification is the process of
   (a) Deciding the test check
   (b) Satisfying the employees
   (c) Dividing the population into different classes
   (d) Dividing the audit work among the assistants

15. Rent received is valued on the basis of
   (a) Rent Register, cash book
   (b) Ledger
   (c) Purchase Journal
   (d) Building A/c
1.8.4 Match the followings.

<table>
<thead>
<tr>
<th>Group A</th>
<th>Group B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial statement</td>
<td>(a) Users of information</td>
</tr>
<tr>
<td>2. Bankers</td>
<td>(b) As obtain credit worthiness</td>
</tr>
<tr>
<td>3. Trade creditors</td>
<td>(c) Systematic recording of transactions</td>
</tr>
<tr>
<td>4. Book-keeping</td>
<td>(d) Expression of opinion</td>
</tr>
<tr>
<td>5. Primary objective of auditing</td>
<td>(e) Intentional error</td>
</tr>
<tr>
<td>6. Fraud</td>
<td>(f) Balance sheet</td>
</tr>
<tr>
<td>7. Theft of asset</td>
<td>(g) Employee fraud</td>
</tr>
<tr>
<td>8. Manipulation of accounts</td>
<td>(h) Management Fraud</td>
</tr>
<tr>
<td>9. Accounting</td>
<td>(i) Begins when book keeping ends</td>
</tr>
<tr>
<td>10. Auditing</td>
<td>(j) Goes beyond auditing</td>
</tr>
<tr>
<td>11. Investigation</td>
<td>(k) A technique of fraud</td>
</tr>
<tr>
<td>12. Teeming and lading</td>
<td>(l) Not restricted to book of accounts only</td>
</tr>
<tr>
<td>13. Auditors</td>
<td>(m) Report to shareholder</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group A</th>
<th>Group B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Concurrent audit</td>
<td>(a) Done by frequent visit to the organization</td>
</tr>
<tr>
<td>2. Continuous</td>
<td>(b) Done to evaluate efficiency</td>
</tr>
<tr>
<td>3. Efficiency audit</td>
<td>(c) Mandatory</td>
</tr>
<tr>
<td>4. Statutory audit</td>
<td>(d) Some transactions examined</td>
</tr>
<tr>
<td>5. Partial audit</td>
<td>(e) Done at the end of the year</td>
</tr>
<tr>
<td>6. Final audit</td>
<td>(f) Audit with the occurrence of the transactions</td>
</tr>
<tr>
<td>7. Special audit</td>
<td>(g) Under section 233A of the companies act, 1956.</td>
</tr>
<tr>
<td>8. Terms of engagement</td>
<td>(h) Identified by AAS8</td>
</tr>
<tr>
<td>9. Sources of information</td>
<td>(i) Contains useful information about clients business</td>
</tr>
<tr>
<td>10. Audit memorandum</td>
<td>(j) A blue print of audit work to be done</td>
</tr>
<tr>
<td>11. Audit programme</td>
<td>(k) Available for future reference</td>
</tr>
<tr>
<td>12. Audit note book</td>
<td>(l) Audit working papers</td>
</tr>
<tr>
<td>13. Bank reconciliation statement</td>
<td>(m) Tick mark used in original recort</td>
</tr>
<tr>
<td></td>
<td>(n) AAS26</td>
</tr>
<tr>
<td></td>
<td>(o) Minutes of meetings</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Group A</th>
<th>Group B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Internal control</td>
<td>(a) Instituted by management.</td>
</tr>
<tr>
<td>2. Internal control</td>
<td>(b) Step in internal control</td>
</tr>
<tr>
<td>3. Inspection of quality</td>
<td>(c) Bogus workers</td>
</tr>
</tbody>
</table>
## Introduction to Auditing

4. Ghost workers  
   (d) Prevention of frauds  
5. Object of internal control  
   (e) Whole system of control  
6. Internal Auditor  
   (f) Appointed by the management  
7. Lottery method  
   (g) Appointed by the Government  
8. Cluster sampling  
   (h) Non-random sampling  
9. Stratified sampling  
   (i) Restricted random method  
10. Internal control  
    (j) Reliable information  
11. Revised standard 530  
    (k) Audit sampling  
    (l) Simple random sampling

### 1.8.5 Write short note on.

1. Object of Auditing  
2. True and Fair view  
3. Balance sheet Audit  
4. Occasional Audit  
5. Lien on working papers  
6. Audit programme  
7. Internal control  
8. Test checking