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SECTION-1 (AUDITING)

INTRODUCTION TO AUDITING

STRUCTURE:

1.1 OBJECTIVES

After studying this unit you will be able to understand

a. the evolution of auditing

b. the objects of auditing

c. the advantages and disadvantages of auditing

d. detection and prevention of frauds and errors

e. limitations of auditing

1.2 INTRODUCTION -AN OVERVIEW OF AUDITING:

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the barfly makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions

As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.3 ORIGIN AND EVOLUTION

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them

Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances.

The original objective of auditing was to detect and prevent errors and frauds

Auditing evolved and grew rapidly after the industrial revolution in the 18th century With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.

The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

In India the companies Act 1913 made audit of company accounts compulsory

With the increase in the size of the companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts

The companies Act.1913 also prescribed for the first time the qualification of auditors

The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the. accountants and auditors in the day to day work

The later developments in auditing pertain to the use of computers in accounting and auditing.

In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

1.4 DEFINITION

The term auditing has been defined by different authorities.

1. Spicer and Pegler: "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

2. Prof. L.R.Dicksee. "auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate.

3 The book "an introduction to Indian Government accounts and audit" "issued by the Comptroller and Auditor General of India, defines audit “an instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor."

1.5 FEATURES OF AUDITING

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

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

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

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

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

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

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

1.6 OBJECTIVES OF AUDITING

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

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

b. **Secondary objective –** it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objective of auditing are:
   i. Detection and prevention of Frauds, and
   ii. Detection and prevention of Errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated.

Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. Clerical errors.

1.7 EXPRESSION OF OPINION

When we speak of the objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exists as to distort what the accounts should really convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statement in such a way as to enable the reader of the accounting statement to form a correct view of the slate of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's Case* as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective; it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statement show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors of frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.
If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston*

Cotton Mills Co.

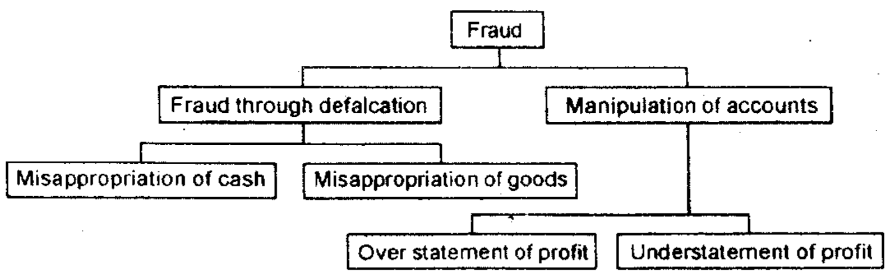
1.8 DETECTION OF FRAUD & ERRORS

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.

a. Defalcation involving misappropriation of either cash or goods; and

b. Fraudulent manipulation of accounts not involving defalcation.

1.8.1. FRAUD COVERS THE FOLLOWING



1.8.2 FRAUD THROUGH DEFALCATION.

Following are the methods of defalcation involving misappropriation of cash or goods

1 By misappropriating the receipt by not recording the same in the cashbook

2 By destroying the carbon copy or counter foil of the receipt and misappropriating the cash received

3 By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book

4 By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.

5 By omitting to record cash donations received by non-profit making charitable institutions

6 By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.

7 By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.

8 By adopting the method of "teeming and lading" or "lapping process". Under this method cash received from one debtor is misappropriated and deficiency in that debtors account is made good when another payment is received from second debtor by crediting the second debtors account less by that amount. This process is carried out round the year.

9 By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.

10 By misappropriating the sale proceeds of VPP sales or sales of goods on approval basis by treating the transaction as goods received or not approved.

11 By under casting receipt side total of the cashbook

12 By recording fictitious or bogus payments

13 By recording more payments than actual amounts paid by altering the figures on the vouchers.

14 By showing the same payment twice.

15 By showing credit purchases as cash purchases and misappropriating the amount

16 Recording personal expenses as business expenses

17 By not recording discounts and allowances given by the creditors and misappropriating the amounts

18 By overcasting the payment side total of the cashbook

19 Recording fictitious and inflated purchases and misappropriating that amount.

20 By suppressing the credit notes for returns and showing the full payment to creditors.

21 By including the names of dummy workers or the workers who have? The job in the wage sheets and misappropriating the amount.

22 By over casting the total of wages sheets and drawing that amount for misappropriation.

23 By misappropriating the undisbursed wages.

1.8.3 FRAUD THROUGH MANIPULATION OF ACCOUNTS

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Generally this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

1.8.4 THE AUDITOR CAN SUSPECT FRAUD UNDER THE FOLLOWING CIRCUMSTANCES.

1. When vouchers, invoices, cheques, contracts are missing etc.

2. When control account does not agree with subsidiary books.

3. When the difference in trial balance is difficult to locate.

4. When there are greater fluctuation in G.P. and N.P. ratios.

5. When there is difference between the balance and the confirmation of the balance by the parties.

6. When there is difference between the stock as per records and the stock physically counted.

7. When the explanation given by the client is not satisfactory.

8. When there is a overwriting of some figures.

9. When there is a contradiction in the explanation given by different parties.

1.8.5 PROCEDURE TO BE FOLLOWED TO DETECT 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 unposted.

1.8.6. 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.

1.9 ADVANTAGES AND INHERENT LIMITATIONS OF AUDIT

1.9.1 ADVANTAGES OF AUDIT

Advantages of audit

A. Businessman's point of view	B. Investor's point of view	C. Other Advantages.
1 Detecfonof errorsandfrauds	1 . Protects interest	1. Evaluate financial status
2 Loan from banks	*2.* Moral check	*2.* Usting of shares
3 Builds reputation	3. Proper valuation of investments	3. Settlements of claims
4 Proper valuation of assets	4 Good security	4 Evidence in court
5. Government acceptance		5. Settlement of accounts
6. Update accounts		5. F aciStates calcu lation of Purchase. Conskteraton.
7 Suggestions for improvement		7 Facilitates taxation
8. Useful for agency		

1.9.2 LIMITATIONS OF AUDITING

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expresses by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. Further, the process of auditing is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of an audit procedure. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the overall objectives of an audit. The inherent limitations are:

I. First of all, auditor's work involve exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

II. The entire audit process is generally dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to records transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal controls system also contribute to inherent limitations of an audit.

Generally following are the Limitations of auditing

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, Architects etc. he can not 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 judgement 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 favourable 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 can not be measured. Audited statements due to these limitations can not exhibit true position.

9. **Detailed checking not possible :-** Auditor cannot check each and every transaction. He may be required to do test checking.

1.10 MISCELLANEOUS

1.10.1 AUDITING Vs INVESTIGATION

Points of difference	Auditing	Investigation
1. objects	The object is to find out whether balance sheet and profit and loss account exhibit a true and fair view of business.	It is undertaken to know the essential facts about a matter under inquiry. It is done with some special purpose of view.
2 period	It usually covers one accounting year.	It may cover more than one accounting year.
3 conducted	It is conducted for proprietors only.	It is carried out on behalf of any party interested in the matter.
4 scope	It is restricted to balance sheet and profit and toss account.	It is wider in scope. It may be carried out beyond balance sheet.
5. compulsion	Audit is legally compulsory for companies.	It is voluntary. It is required under certain circumstances.
	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction.
		Form of report is not

		prescribed. It is presented to the client.
6 time	Form of report is prescribed. It is presented to the shareholders.	Even third party can appoint an investigator.
7. report	Owners appoint the auditors.	Even an employee preferably a chartered accountant may be appointed as investigator.
8. appointment	The statutory auditors must posses proper qualifications.	Re - investigation may be undertaken.
9. qualifications	Re - audit is not generally undertaken.	
10. rework		

1.10.2 DISTINCTION BETWEEN ACCOUNTING AND AUDITING

Points of difference	Accounting	Auditing
1. meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. nature	It is concerned with finalisation of accounts.	It is concerned with establishment of reliability of financial statements.
3. objects	The object is to ascertain the trading results.	The object is to certify the correctness of financial statements.
4. commencement	Accounting commences when book keeping ends.	Auditing begins when accounting ends.
5. scope	It involves various financial statements. It involves maintenance of books of accounts. It does not go beyond books of accounts.	It depends upon the agreement or upon the provisions of law. It goes beyond books of accounts.

1.10.3 TRUE AND FAIR VIEW.

An audit of accounts by an independent expert assures the outside users that the accounts are proper and reliable. The outsiders can rely on the accounts if the auditor reports that the accounts are true and fair. The accounts are said to be true and fair:

1. **When the profit and loss shown in the profit and loss account is true and fair, and**

2. **Also when the value of assets and liabilities shown in the balance sheet is true and fair.** What constitutes true and fair is not defined under any law. However the following general guidelines may be laid down in connection with true and fair.

   a) **Conform to accounting principles:** The books of accounts must be kept according to the normally accepted accounting principles such as the concept of entity, continuity, periodical matching of costs and revenue, accrual and double entry system etc.

   b) **No window dressing or secret reserves:** The accounts must show the financial position and the profit or loss as they are. I.e. there is neither an overstatement nor an understatement. There should be in other words neither window dressing nor secret reserves. In window dressing the accounts are made in such a way as to show a much better condition than the actual condition. The profit and the net worth are overstated

      The accounts are said to show true and fair view when the accounts show only the actual conditions as it is. i.e. the profit and the net worth are shown as they are.

In order to show a true and fair view the auditor should ensure that:

1. The final accounts agree with the books of accounts.

2. The provision for depreciation is proper.

3. The closing stock is physically verified and valued properly.

4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.

5. Proper provision is made for bad and doubtful debts.

6. Capital expenses is not treated as revenue expenses and vice versa.

7. Capital receipts are not treated as revenue receipts.

8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.

9. Contingent liabilities are not treated as actual liabilities and vice versa.

10. Provision is made for all known losses and liabilities

11. A reserve is not shown as a provision and vice versa

12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.

13. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income are recorded properly.

14. Expected or anticipated gains are not credited to the profit and loss account.

15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly

16. The exceptional or non-recurring transactions are disclosed separately in the accounts.

3. Disclose all material facts: The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities. Material means important and essential. The disclosure of important matters in the accounts helps the users in taking business decisions. There should be neither suppression of vital facts nor mis-statements.

4. Legal requirements: In case of limited company the account must disclose the matters required to be disclosed under the Companies Act. The final accounts must be in the format prescribed under Schedule VI of the Companies Act, 1956. Special companies such as banks, insurance, electricity supply companies prepare accounts as prescribed under special laws. A co-operative society, a trust etc. must also prepare the accounts as required under relevant laws.

5. Requirements of Institute of Chartered Accountants of India: The accounts must also be in accordance with the various guidelines prescribed by the ICAI. These guidelines are contained in the statements, standard and guidance notes issued by the institute from time to time.

1.10.4 ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Apart from this abvious utility, there are other advantage of audit. Some or all of these are of considerable value even to those enterprises and organization where audit is not compulsory, these advantages are given below:

(a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(b) It acts as a moral check on the employees from committing defalcations or embezzlement.

(c) Audited statements of account are helpful in setting liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(d) This are also use for settling trade disputes or higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastage and losses to show the different ways by which these might be checked, especially those that occur due to the absence of inadequacy of internal checks or internal control measures.

(f) Audit ascertains whether the necessary books of accounts and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respects.

(g) As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weakness, inadequacy, etc., in them.

(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(i) Government may require audited and certificated statement before it gives assistance or issues a licence for a particular trade.

1.10.5 QUALITIES OF AN AUDITOR

So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important.

Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. AAS-8 on 'Audit Planning' emphasises that an auditor should have adequate knowledge of the client's business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

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

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

1.13 LET US SUM UP

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation. Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into a) primary objective and b) secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds.

A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit.

Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

1.14 KEYWORDS

Auditing: Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

Continuous audit: An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

Errors: Mistakes committed innocently and unknowingly while making entries in the books of accounts.

Frauds: Fictitious entries made in the books of accounts with certain motives.

Interim audit: An audit which is conducted for a part of the accounting period for some specific purpose.

Investigation: Examination of accounts for special purpose.

Qualified auditor: A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act,1949.

Statutory audit: An audit undertaken under any specific statute or Act.

True and fair view: A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain **errors** and fraud.

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1.16 QUESTIONS

1. Check your progress

i) Define auditing.

ii) Distinguish between accountancy and auditing.

iii) State whether the following statements are true or false.

a) Auditing of accounts is compulsory in a partnership firm.

b) Auditing of accounts is undertaken to detect fraud in the books of accounts.

c) A professional auditor cannot take up the work of preparing the accounts of a company.

d) Investigation is taken up only on behalf of the owner of the entity.

e) Investigation of accounts is not compulsory but audited by the qualified professional accountant.

f) In ancient period the audit was confined to cash audit and not to locate fraud.

g) Audit of company accounts is compulsory under the Chartered Accountants Act, 1949.

2. Check your progress

1. List the types of clerical errors.

2. Distinguish between errors and fraud.

3. What do you mean by window dressing.

4. Fill in the blanks with the appropriate word given in the bracket:

   a) when two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as ______(error of omission/compensating error)

   b) —————————are always committed deliberately and intentionally to defraud the proprietors of the organisation (error/fraud)

   c) the main objective of —————————is to avoid or reduce the tax liability.(window dressing/secret reserves)

   d) to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is—————————of an audit .(primary objective/secondary objective)

5 State whether the following statements are true or false.

   a) The main object of auditing is to detect frauds from the books of accounts.

   b) The allocation of amount between capital and revenue expenditure is a compensating error.

c) Audited accounts are free from errors and fraud.

d) The main purpose of auditing is to report on the efectiveness of the internal check system of organisation.

e) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.

f) The auditor is appointed to report on the financial position of the company carrying out an analytical examination of the books of accounts related documents and internal and external evidences.

g) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.

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2

INTRODUCTION TO AUDITING II

STRUCTURE:

2.0 OBJECTIVES

After studying the unit the students will be able to

- Understand the meaning of Errors and Frauds
- Classify the reasons and circumstances of errors and frauds.
- Explain the types of Errors and fraud
- Elaborate the Authors duty in case of Errors and frauds.
- Explain the types of Audit
- Understand the principles of Audit

2.1 MEANING AND DEFINITION OF ERRORS AND FRAUDS

DEFINITIONS :

Error refers to unintentional mis-statements or mis-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 :

(a) Principal Errors and (b) Clerical Errors

(a) principal Errors and : these errors arise generally when the principals of accountancy are not observed while recording a transaction. For instance a capital expenditure is recorded as a 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 :

(1) Wages paid for installation of plant and machinery is recorded as wages paid to workers

(2) Revenue receipt is recorded as a capital receipt
(3) Incorrect provisions for doubtful debts
(4) Incorrect provisions for discount on debtors
(5) Rent paid to landlord debited to the landlord account instead of rent ac account
(6) Overvaluation or undervaluation of stock on account of ignorance

(b) 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.

2.2 REASONS AND CIRCUMSTANCES

R.K. Mautz, has classifieds the reasons and circumstances of errors and he has include fraud in the broad category of errors. The classifications are the following.

1. ignorance on the part of employees of accounting development, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortage of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever presents desires to hold taxes on income to minimum.

A sixth cause may be added to those Mr.Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in positions of authority to :

I. Show up the picture depicted by the statements;
II. Depress the picture depicted by the statements; and
III. Convert the error to a personal benefit.

2.3 TYPES OF ERRORS

2.3.1 Commission

It includes posting errors, casting errors and totalling errors. For example ale to A has been recorded in B's A/c, it is a posting error or it is recorded in A's A/c but the amount is wrongly recorded. Similarly the balance of Rs.510 is carried forward as Rs.501, and then it is a casting error. Certain errors will not affect the trial balance for example posting in a wrong account will not affect the trial balance but if there is a totalling error or a casting error then the trial balance does not agree.

2.3.2 Omission

In the process of recording the accounting clerk may omit a transaction from recording either fully or partially. If a transaction is fully omitted, then it will be difficult to trace out, as both the debit and the credit are missing and the trial balance will tally inspite of these errors. However if a transaction is partly omitted, then only one aspect of the transaction is recorded. In this case it is easier to locate such an error.

2.3.3 Principle and compensating

PARTICULRS	PRINCIPLE	COMPENSATING
MEANING	A Transaction Is Basically Recorded In The Books In An Incorrect Manner.	An error which is counter balanced by another error, so that it is not disclosed by the trial balance.
Types.	(a) **errors which do not affect profit:** e.g. manufacturing wages posted to trade expenses A/C or wrong classification of assets or Liabilities. (b) **Error which affect profit :** e.g. treating rent paid as a debtor instead pf as expenses, when capital expenditure is treated as revenue and debited to P&L account.	It may or may not affect profit. If both original and compensating errors arise in revenue accounts, profit will not be affected, but if one arises in a revenue account and other in an asset or liability account, trial balance will agree, but profit will be incorrectly stated. It arises in various ways, most frequently in casting, e.g., cast of expenditure account may be Rs.96,000 too much, profit and asset being thereby shown improperly.
3 Effect on trial balance.	These errors will not affect the trial balance.	These errors will not affect the trial balance.
Effect on profit	Error that involves income and expenditure a/c e.g. wrong distinction between capital and revenue	Compensating errors, involving income and affect profit. But if error is in asset and liability accounts only, profits may not be

	expenditure will affect profit.	affected.
Detection	These errors are detected by audit procedures like analytical reviews, ledger scrutiny, analysis of comparative financial statements, etc.	Such errors are generally deliberately concealed and hence difficult to detect. Audit procedures like analytical review, posting checking, ledger scrutiny, etc. can partly help to locate these errors.

2.4 TYPES OF FRAUDS

According to the standard Auditing practices issued by the Institute of Chartered Accountants of India, the term fraud refers to intentional misrepresentation of finance information by one or more individuals among management or third parties. In other words, it is intentional or wilful misrepresentation r deliberate concealed of a material fact with a view to deceive, cheat or mislead another person.

Frauds may be of different types:

i) Manipulation of accounts,
ii) Misappropriation of cash,
iii) Misappropriation of Goods.

2.4.1 Manipulation of Accounts

Manipulation of accounts is said to be committed when a person makes a false entry in the books of accounts knowing it to be wrong, alters or destroys a true entry in the business records or prevents the making of a true entry in the business records. Normally it is done by people at the top management level. It is done to overstate or understate the profits and the financial conditions of the business so as to serve their purpose. Manipulation may be done in any of the following ways :

1) Non provisions of depreciation on fixed assets
2) Overvaluation or undervaluation of assets
3) Recording revenue expenditure as capital expenditure
4) Showing expenses of the next year in the current year's profit and loss account
5) Not recording currents year's accrued expenses etc.

A comm0on form of manipulation of accounts is known as "window Dressing."

2.4.2 Misappropriation of Cash

Misappropriation of cash is also called embezzlement of cash. It means fraudulent appropriation of cash belonging to another person by one who has been entrusted to it. Misappropriation may take place in the following ways:

1) Not recording full cash sales and pocketing a part of the proceeds
2) Teeming and Lading
3) Misappropriation the money received from sale of goods sent on sale or return basis
4) Making fictitious entries in customer's accounts for bad debts, discount etc.
5) Misappropriation the amount received from sale of defective goods by not recording such sale
6) Recording fictitious cash purchase
7) Recording payments to fictitious creditors
8) Not recording discounts received from creditors
9) Recording payments to dummy or ghost workers and pocketing the money, etc.

2.4.3 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.

2.5 RISK OF FRAUD AND ERROR IN AUDIT

The following events may increase the risk of fraud or error -

1. **Internal Control Faults:** Weaknesses in the design of internal control system and non-compliance with laid down control procedures, e.g. a single person being responsible for receipt of all pasts/ mails and marking it ti the relevant secions or two persons responsible for receipt of all posts/ mails but the same is not followed in the practice.

2. **Doubts about the integrity or competence of the management,** e.g. domination by one person, high rate of employee turnover, frequent change of legal counselsof Auditors, significant and prolonged understaffing of the accounts department, etc.

3. **Unusual pressures within the entity,** e.g. industry is doing well but the Company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support the share market price, etc.

4. **Unusual transactions** e.g. transactions with related parties, excessive payment for certain services to lawyers, etc.

5. Problems in obtaining sufficient and appropriate audit evidence,

E.g. inadequate documentation significant differences between the figures as per accounting records and confirmation received from third parties. Etc.

2.6 AUDITOR'S DUTIES AND RESPONSIBILITIES IN RESPECT OF FRAUD

The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement pf the financial statement resulting from fraud or error does not, in and of itself, indicates:

a) Failure to obtain reasonable assurance,
b) Inadequate planning, performance or judgment,
c) Absence of professional competence and due care, or,
d) Failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management. Those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's reports based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error. Which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a significant fraud, the same should be disclosed in the financial statement. If adequate is not made, there should be a suitable disclosure in his audit report.

2.7 BASIC PRINCIPLES OF AUDIT

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

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

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

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

examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others:

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

5. Documentation:

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

6. Planning:

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

7. Audit evidence:

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

8. Accounting system & internal control:

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

9. Audit conclusions and reporting:

The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.

2.8 AUDIT TYPES

MEANING:

Audit is not legally obligatory for all types of business organizations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

(i) Audit required under law : The organizations which require audit under law are the following:

(a) companies governed by the Companies Act, 1956;
(b) banking companies governed by the Banking Regulation Act, 1949;
(c) electricity supply companies governed by the Electricity supply Act, 1948;
(d) co-operative societies registered under the co-operative Societies Act, 1912;
(e) public and charitable trusts registered under various Religious and Endowment Acts;
(f) corporations set up under an Act of parliament or State Legislature such as the Life Insurance Corporation of India.
(g) Specified entities under various sections of the Income-tax Act, 1961.

(ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. in respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purpose like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited.

Government companies have some special feature which will be seen later.

INTERIM AUDIT:

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

CONTINUOUS AUDIT:

A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period.

A continuous audit is preferred for the following reasons:

i. It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors of frauds uncovered by such an audit.
ii. The frequent attendance by the staff deters persons so inclined, from committing a fraud.
iii. The accounting staff of the client is motivated to keep the books of account up-to-day.

2.9 ACCOUNTING CONCEPT RELEVANT TO AUDITING

INTRODUCTION

1. The purpose of this standard is to establish standards on the concept of materiality and its relationship with audit risk.
2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

2.9.1 MATERIALITY:

1. Information is material if its misstatement (i.e., omission or erroneous Statement) could influence the economic decisions of users taken on the Basis of the financial information. Materiality depends on the size and Nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

2. The objective of an audit of financial information prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is materiality of professional judgment.

3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity at

both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and consideration relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

4. Although the auditor ordinary establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misted by the description.

5. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedures could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.

6. Materiality should be considered by the auditor when-

(a) Determining the nature, timing and extent of audit procedures;
(b) Evaluating the effect of misstatements.

2.9.2 GOING CONCERN:

1. The purpose of this Auditing and Assurance standard (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuous as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, asset and liabilities are recorded on the normal course of business. If this assumption is unjustified, the entity

may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statement may need to be adjusted.

APPROPRIATENESS OF THE GOING CONCERN ASSUMPTION

I. The auditor should consider the risk that the going concern assumption may no longer be appropriate.

II. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

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3

AUDIT PLANNING

STRUCTURE:

3.0 OBJECTIVES

After studying the unit the students will be able to

- Define Audit Planning
- Understand the Objectives of Audit Planning
- Understand the Meaning of Audit Programme
- Explain the factors, advantages and disadvantages of Audit Programme
- Know the meaning of Audit Papers.

3.1 MEANING

As per Auditing and Assurance Standard 1, "Basic Principles Governing an Audit", Audit Planning is one of the basic principles. Accordingly, it states

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business. Plans should be made to cover, among other things:

(a) Acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) Establishing the expected degree of reliance to be placed on internal control;

(c) Determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit."

AAS-8 further expounds this principle. According to it, planning should be continuous throughout the engagement and involves

- Developing an overall plan for the expected scope and conduct of the audit; and
- Developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan of and the audit programme. The reasons for significant changes may be documented.

3.2 OBJECTIVES OF PLANNING

Adequate audit planning helps to:

- Ensure that appropriate attention is devoted to important areas of the audit.
- Ensure that potential problems are promptly identified;
- Ensure that the work is completed expeditiously;
- Utilize the assistants properly; and
- Co-ordinate the work done by other auditors and experts.

In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates his previous experience with the client and knowledge of the client's business.

The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

3.3 FACTORS TO BE CONSIDERED

_Planning his audit, the Auditor will consider the following factors -

Complexity of the Audit: The scope of work and reporting responsibilities is analyses in order to determine the complexity of audit.

Environment in which the entity operates: This enables the Auditor to understand various operational aspects of audit, e.g. extent of computerization, nature of internal controls, general attitude of personnel, etc.

Previous experience with the client: By analysing the previous year's audit working papers and other relevant files, the Auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

Knowledge of the client's business: This is required to establish the overall audit plan. The Auditor will be able to - (a) identify areas of special audit consideration, (b) evaluate the reasonableness both of accounting estimates and management representations, and (c),make judgments regarding the appropriateness of accounting policies and disclosures.

Discussion with Client: The Auditor can discuss his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit Programme, however, remain the Auditor's responsibility.

3.4 SOURCES OF OBTAINING INFORMATION

Sources of information listed under AAS - **8:** The Auditor should obtain a level of knowledge of the client's 'ness that will enable him to identify the events, transactions and practices that, in his judgment, may have iificant effect on the financial information. The Auditor can gain knowledge of client's "business from –

The client's Annual Reports to Shareholders.

Minutes of Meetings of Shareholders, Board of Directors and important Committees.

'ntemal Financial Management Reports for current and previous periods, including Budgets, if any.

Previous year's Audit Working Papers, and other relevant files. ,

Prim Personnel responsible for non-audit services to the client who may be able to provide information on

natters that may affect the audit.

Discussions with Client.

Client's Policy and Procedures Manual.

Relevant publications of the ICAI and other professional bodies, Industry Publications, Trade Journals,

Magazines, Newspapers or Textbooks.

Consideration of the state of the economy and its effect on the client's business.

Visits to the client's premises and plant facilities.

Discussion with client:
ording to AAS - 8, during the course of planning the audit, discussions with the client might include the wing subjects -

Changes in Management, Organisational Structure, and activities of the client.

Current Government Legislation, Rules, Regulations and Directives affecting the client.

Current Business Developments affecting the client.

Current or impending Financial Difficulties or Accounting Problems.

Existence of Interested Parties and transactions with them.

3.5 DEVELOPMENT OF AN OVERALL PLAN

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are the act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(i) That the date of the voucher falls within the accounting period;

(ii) That the voucher is made out in the client's name;

(iii) That the voucher is duly authorized;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) That the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

3.6 MEANING OF AUDIT PROGRAMME

MEANING:

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

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

1. stay within the scope and limitation of the assignment.
2. determining the evidence reasonable available and identify the best evidence for deriving the necessary satisfaction.
3. Apply only these steps and procedures which are useful in accomplishing the verification purpose In the specific situation.
4. consider all possibilities of error.
5. co-ordinate the procedures to be applied to related items.

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

3.7 FACTORS ADVANTAGES AND DISADVANTAGES OF AUDIT PROGRAMME

3.7.1 FACTORS

While construction an audit programme, the Auditor should keep the following points in his mind-

1. to operate within the scope and limitations of the assignment.
2. to determine the avidence reasonably available and identify the best avidence for deriving the necessary satisfaction.
3. to apply only those steps and procedures, which are useful in accomplishing the verification purpose in the specific situation.
4. to consider all possibilities of error.
5. to co-ordinate the procedures to be applied to related items.

3.7.2 ADVANTAGES OF AUDIT PROGRAMME

a. It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
b. It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
c. Selection of assistants for the jobs on the basis of compatibility becomes easier when the work is rationally planned, defined and segregated.
d. Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.
e. The assistance, by putting their signature on programme, accepts the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
f. The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
g. It serves as a guide for audits to be carried out in the succeeding year.
h. A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

3.7.3 DISADVANTAGES OF AUDIT PROGRAMME

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

b. The programme often tends to becomes rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

c.Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instructions in the matter is contained therein.

d. A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observed matters objectively and bring significant matters to the notice of supervisor/principal.

3.8 AUDIT WORKING PAPERS

3.8.1 MEANING:

The audit working papers constitute the link between the auditor's report and the client's records. Documentation is one of the basic principles listed in AAS 1. according to AAS 3 (reproduced in Appendix l), documentation refers to working papers prepared or obtained by the auditor and retained by him in connections with performance of his audit. The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another. Therefore, working papers should provide for:

a) Means of controlling current audit work;
b) Evidence of audit work performed;
c) Schedules supporting or additional item in the accounts; and
d) Information about the business being audited, including the recent history.

Working papers are varied in nature but the foundation of all working paper can be traced to:

1. the basic constitutional document like memorandum and Articles of association, partnership Deed, trust deed, etc.;
2. the contents of the minute books;
3. the contents of the balance sheet and the profit and loss account; and
4. the letter of engagement.

3.8.2 IMPORTANCE OF AUDIT WORKING PAPERS:

I. IT provides guidance to the audit staff regard to the manner of checking the schedules.
II. The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.

III. It acts as an evidence in the court in the court of law when a charge of negligence is brought against the auditor.
IV. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retained them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

3.8.3 FACTOR DETERMINING FORM AND CONTENTS OF AUDIT WORKING PAPERS:

Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The form and content of working papers are affected by matters such as:

- Nature of the engagement.
- Form of the auditor's report.
- Nature and complexity of the client's business.
- Nature and condition of the client's records and degree of reliance on internal controls.
- Need in particular circumstances for direction, supervision and review of work performed by assistants.

Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardization of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of the documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration, consideration or conclusion is documented by the auditor in his working papers.

3.8.4 A Permanent Audit File

A permanent audit file normally includes

- Information concerning the legal and organizational structure of the entity. In case of a company, this includes the memorandum and Article of association. In the case of a statutory corporation, this includes the act and regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minute relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

3.8.5 The Current File

The current file normally includes

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of board meetings and general meetings as relevant to audit.
- Evidence of the planning of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communication with other auditors, experts and other third parties.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on the related audit reports.

3.8.6 MAIN FUNCTIONS/ IMPORTANCE

i. It provides guidance to the audit staff with regards to the manner of checking the schedules.
ii. The auditor is able to fix responsibility on the staff member who sign each schedule checked by him.
iii. It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
iv. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirement of record retention.

Clarification On The Auditor's Rights Where Clients And Other Auditors Seek Access To Their Audit Working Papers.

1. Auditing and Assurance standard (AAS) 1, "Basic principles governing an audit", states in para6: "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclosed any such information to a third party without specific authority or unless there is a legal or professional duty to disclosed". Auditing and Assurance standard (AAS) 3, "Documentation" (paragraph 13), states: 'working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client. "AAS 3 further requires (paragraph 14)",inter alia, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers."

2. part I of the second schedule to the chartered Accountants Act, 1949, provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he disclosed information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."

3. Request are sometime received by the members of the institute, who have/had been performing the duties as the auditor of an enterprises, to provide access to their audit working papers. The request may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.

4. It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary,

access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

5. As stated in para 4, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in case considered appropriate by him, make portions of or extracts from his working papers available to the client.

3.8.7 FEATURES

As audit working papers are quite useful they should be prepared properly. They should have the following essentials:

a) **Standard form -** they should be prepared in a standard form. The subject matter should be arranged under various heading and sub-headings.
b) Proper layout – there should be proper design and layout of the working papers. This will bring uniformity into the maintenance of working papers.
c) **Space for margins –** there should be enough space for margin after each note for noting down the auditor's remarks and decisions.
d) **proper organisation and arrangement –** the working papers should be properly organized and arranged. In other words the working papers should be so organized and arranged that the auditor will be able to locate any particular matter easily.
e) **Completeness –** the audit working papers should be complete in all respects. They should contain detailed information on all essential facts or points.
f) **Clarity and Accuracy** – the working papers should be quite clear and self explanatory. The information contained in the working papers should be accurate.
g) **Good quality paper** – paper of good quality should be used for working papers as they are subject to frequent handling further the paper used should be of uniform and convenient size so that they can be easily filed.

3.8.8 OWNERSHIP, AND CUSTODY OF WORKING PAPERS

Working papers are the property of the auditor. The auditor may, at his discretion may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the property of the auditor and he is entitled to retain them. (chantery martin & co. v. martin).

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4

AUDITING TECHNIQUES AND INTERNAL AUDIT INTRODUCTION I

STRUCTURE

4.0 OBJECTIVES

- Know the meaning of Test Checking
- Understand the features of Test Checking
- Know the advantages and disadvantages of Test Checking
- Distinguish between test checking and routing checking
- Understand the meaning of Audit sample

4.1 TEST CHECKING MEANING

4.1.1 Meaning: Examination in Depth means examination of a few selected transactions from the-beginning lo. the end through the entire flow of the transaction. It involves studying the recording of transactions the

various stages through which they have passed **2. Aspects of Verification**

(a) At each stage, relevant records and authorities are examined; it is also judged whether the person who has | exercised the authority in relation to the transactions is fit to do so in terms of-the prescribed procedure.

(b) While auditing in depth, the Auditor reviews all the accounting and operational aspects of the| transaction from the origin to the end. This enables him to have an overall view and evaluate the procedures through selected transactions.

3. A Representative Sample must be open and each item selected must be traced meticulously. :

4. A smaller number of transactions are checked at each successive stage with a in-depth test, on statistical grounds (based on probability theory) that the optimum sample size decreases as the Auditor's "level oft confidence" concerning the functioning of the system increases.

5. Examination in depth reconstructs the audit trail and reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing

6. Example: Audit in depth of transactions relating to purchase of goods involves verification of the following

(a) Purchase Requisition - pie-printed, pre-numbered and authorised;

(b) Invitation of quotations and analysis of the same;

(c) Official Purchase Order, sequentially pre-numbered, authorised and placed with approved suppliers only;

(d) Receipt of goods, together with Delivery Challan / Advice Note;

(e) Admission of goods to stores after verification of quality, quantity etc.;

(f) Entry in Stores Records;

(g) Receipt of Supplier's Invoice and Statement;

(h) Approval of Purchase Invoice regarding compliance for specification, quantity and quality;

(i) Entries in Purchases day book;

(j) Postings to Purchase Ledger and Purchase Ledger Control Account;

(k) Payment of Cheque in settlement of invoice after availing discounts; if any;

(1) Entry for payment in Cash / Bank Book;

(m) Posting from Cash Book to Ledger and Control Accounts.

1. Test Checking means to select and examine a representative sample from a large number of similar items.

2. Test Checking is an accepted auditing procedure wherein instead of checking all transactions, only a part of it is checked in detail to form an opinion on the whole

4.2 FEATURES OF TEST CHECKING

Test checking consists of selecting and checking a proportion of transactions selected by the Auditor. The salient features of Test Checking are -

1. Scientific: It is a mathematical truth that a scientifically selected sample would reveal the features and characteristics of the population. The statistical theory of sampling is based on a scientific law. Hence, it can be relied upon to a greater extent than any arbitrary technique which lacks basis and acceptability.

2. Estimation Process: Test Checking and Sampling can never .bring complete reliability; it cannot give accurate results. It is a process of estimation. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular

3. Coverage of material items: Entries involving large amounts or relating to material accounts are ..seen exhaustively and other entries are picked up for verification from the remainder according to a certain plan. Sometimes entries are checked for a few specified months exhaustively and the rest go unchecked.

4. Full Coverage over a time period: Test Check is normally planned in such a way that the audit programmes for 3 to 5 years cover all types of transactions in case of a medium or large sized Company. Thus, if in one year the months of January, June and December are checked; April, July and September may be checked in the second year and so on.

5. Surprise Element: The staff and management of the Auditee Company should not be able to anticipate the pattern of test checking, otherwise they will predict the areas and periods to be covered in any one year and will be careful regarding the same.

6. Flexibility: If test checking becomes routine, predictable and mechanical, it loses its value. Hence, the Auditor should keep changing the methods of test checking at reasonably frequent intervals.

7. Judgment Based: The extent of test checking would primarily depend on the Auditor's judgment of a particular situation. This judgement in turn depends on tne previous experience of the Auditor, current developments and the efficacy of Internal Control System.

4.3 FACTORS TO BE CONSIDERED

The factors to be considered for deciding upon the extent of checking on a sampling plan are -

1. Size of the organization under audit.
2. State and efficacy of the internal control.
3. Adequacy and reliability of books and records.
4. Tolerable error range.
5. Degree of the desired confidence.

WHEN TEST CHECK CAN BE USED?

Test checks can be adopted in the following cases -

1. **Volume of Transactions:** In case of big concerns where number of transactions is quite large.

2. **Time factor:** Where the Auditor has very little time at his disposal to check all the transactions of a medium or large sized concern.

Identical Transactions: When there are a number of transactions of identical and homogeneous nature. **Internal Control:** When there exists a satisfactory internal control system, manual and / or computerized.

4.4 ADVANTAGES AND DISADVANTAGES OF TEST CHECKING

4.4.1 ADVANTAGES OF TEST CHECKING

The advantages of Test Checking include -

Audit Objective: The Auditor is required to form an opinion on the Financial Statements. Even after 100% checking, he may not derive absolute satisfaction. Hence, proper and careful test checking serves the audit objective in obtaining reasonable audit assurance.

Expertise: Application of test check principles involves the application of mind and intelligent judgment. It enables the Auditor to use his expertise effectively.

Exception Principle: Test Checking adopts the principle of exception in control. If certain aspects of internal control do not create suspicion, there is no need to verify all those transactions exhaustively.

Scientific Assessment of Risk: The Auditor assesses the risk of material misstatements in the Financial Statements in a scientific manner by drawing suitable samples and studying the same in detail.

Saving in time: As fewer transactions are verified, time is saved to a great extent. This, in turn, enables completion of all the audits / verification procedures in time.

Reduction in Work: Volume of work is reduced by test checking methods. Audit processes are not carried out mechanically on ail transactions.

4..4.2 DISADVANTAGES PRECAUTIONS

The disadvantages of Test Checking are –

Naive and Biased: The extent to which test checking can be resorted to is a matter of Auditor's personal assessment. It does not ensure selection of representative samples of adequate size and offers opportunities for bias to enter into selection process.

Unauthentic : Test Checking lacks authenticity, precision and an acceptable basis. It does not give the Auditor an idea about the degree of reliability that can be placed on the findings for application to the whole set of entries.

Higher Risk: runs the risk that some of the material error may not be discovered and some of the important areas may go unaudited. Sometimes, it may increase the level of inherent Audit Risk.

Unscientific: It involves lot of arbitrariness on the part of the Auditor in determining and selecting the number of transactions. Therefore, the approach cannot be considered as a scientific one.

Difference in activity levels: Where activity levels vary in a year, e.g. a few months of peak production and sales seasons, the Auditor cannot draw reasonable conclusions about the transactions of the whole year merely by checking transactions of a few specified months.

Lack of Surprise Element: If the surprise element is absent, the client may predict the pattern of checking.

4.5 TEST CHECKING VS ROUTING CHECKING

Particulars	Test checking	Routine checking
Meaning	Test checking is an accepted auditing procedure wherein only a part of its transactions is checked to form an opinion instead of checking the transactions.	Routine checking is the detailed checking of all transactional aspects such as casts, sub – casts, carry-forwards, extensions and calculations etc. in subsidiary books, checking of posting into the ledgers, casting of ledger accounts and extraction of their balances etc.
Objectives	To obtain a reasonable level of satisfaction about all transactions but verifying a few representative transactions called “sample”.	(a) to verify the arithmetical accuracy of the entries, (b) to verify the accuracy of posting to ledgers. © to check that the ledger accounts have been correctly balanced, and (d) to ensure that no figures are altered after checking.
Advantages	(a) Saving in time. (b) Proper and careful test checking is helpful & serves the audit objective. © Volume of work is reduced. (d) Time available for other audits.	(a) Checking of posting and ledgers. (b) Arithmetical accuracy can be checked. © Trial balance tallying is facilitated. (d) Easy detection of errors and frauds. (e) Delegation of audit work to junior staff.
Disadvantages	(a) Client staff may become careless. (b) Some errors and frauds may go undetected. © All items and transactions are not checked. (d) An elements of doubt and risk is present in the Auditor’s opinion.	(a) Is a highly mechanical process. (b) Monotonous activity may lead to boredom. © Major items of frauds and high level intricacies and complexities may not be revealed. (d) Compensating Errors and Errors of Principle will not come to light.

4.6 AUDIT SAMPLING

4.6.1 MEANING:

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

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

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

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

4.6.2 FACTORS IN DETERMINING SAMPLE SIZE- SAMPLING RISK

(1)When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2.

SAMPLING RISK

(2) Sampling risk20 arises from the possibility that the auditor conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

(3) The auditor is faced with sampling risk in both tests of control and substantive procedure as follow:

(a) Tests of control:

(I) Risk of under reliance: The risk that, although the sample result dose not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(II) Risk of over reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such as an assessment.

(b) Substantive procedures:

(I) Risk of incorrect rejection: The risk that, although the sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.

(II) Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.

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

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

Tolerable Error

1. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

16. In tests of control, the tolerable error is the maximum rate of

deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

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

4.6.3 SELECTION OF THE SAMPLE

18. **The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.**

19. While there are a number of selection methods, three methods commonly used are:

Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

Systematic selection, which involves selecting items using *a* constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

* *Haphazard selection,* which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily

located, as they may not be representative.

4.6.4 EVALUATION OF SAMPLE RESULTS

20. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:

(a) analyse any errors detected in the sample;

(b) project the errors found in the sample to the population; and

(c) Reassess the sampling risk.

Analysis of Errors in the Sample

21. In analyzing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be appropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

12. When the expected audit evidence regarding a specific sample item cannot be obtained, he auditor may be able to obtain sufficient appropriate audit evidence through performing Alternative procedures. For example, if a positive account receivable confirmation has been equated and no reply was received, the auditor may be able to obtain sufficient appropriate suit evidence that the receivable is valid by reviewing subsequent payments from the ;customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures,)r if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

>3. The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

24. In analysing the errors discovered, the auditor may observe that many have a common eature, for example, type of transaction, location, product line, or period of time. In such circumstances, the auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The auditor would then perform a separate analysis based on the items examined for 3ach

sub-population.

Projection of Errors

25. The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method jsed to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

Reassessing Sampling Risk

26. The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.

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5

INTERNAL CONTROL

STRUCTURE

5.1 Objectives

5.2 Introduction

5.3 Meaning and definition of internal control

5.4 Forms of internal control

5.5 Internal audit

5.6 Internal check

5.1 OBJECTIVES:

After studying this unit you will be able to

- Explain the meaning and objectives of internal control.
- Enumerate the features of a good internal control system.
- Distinguish between internal audit and statutory audit.
- Describe the meaning and objectives of internal check system.
- Device system of internal check with regard to cash sales.

  credit sales, wages and salaries, purchases, stock etc.
- Explain the duty of the auditor with regard to internal check.
- Understand audit in respect of computerised environment.

5.2 INTRODUCTION

Internal control is another important area of auditing. Internal control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working. In this unit you will learn the meaning and objectives of internal control and internal check. You will also learn various system of internal check and generally understand audit in respect of computer environment.

5.3 MEANING AND DEFINITION OF INTERNAL CONTROL

Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organisation These days business has been become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate. The Internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business.

The American Institute of Public Accountants has defined internal control as the plan of organisation and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments.

The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records".

If we analyze the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves a sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management.

Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. Generally, a system of internal control will include all those measures which assist a business enterprises to fulfill the following objectives.

Objective of internal control

- To minimize, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.

- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.

- To measure how far the policies of the management are being implemented, and

- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

5.4 FORMS OF INTERNAL CONTROL

Various forms of internal control help in ensuring correct and reliable records of transactions and operational efficiencies. Let us discuss them in detail.

Accounting control

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing.

Accounting controls deal with the process of recording of transactions, safeguarding the assets and adherence to prescribed managerial policies

Administrative control

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organisation that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. Time and motion studies, quality control through inspection, statistical analysis and performance evaluation etc. An auditor should make a careful review of accounting controls as they have a direct bearing on the reliability of the financial statements. He is primarily concerned with the accounting controls.

Internal control and auditor

The position of the auditor regarding internal control has been stated in the statement of auditing practices issued by the Institute of Chartered Accountants of India which says "the duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguard and internal controls instituted by the management, although he will take into account the deficiencies, he may note therein while drafting his audit program". It clearly means that an auditor is concerned only with the evaluation of internal control to know its strength and weaknesses. In case he finds that the internal control system is inadequate, he should then plan to carry out detailed examination of those areas where the system is weak. It is therefore necessary for the auditor to acquaint himself fully with the internal control in force and their actual operation. It will help him in the formulation of his audit program. He may also bring the shortcomings of the internal control system to the notice of the management.

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Requisites of a good internal control system

The following are the essential requisites of a good internal control system :-

i. A well developed plan of organisation with proper delegation of functional responsibilities should be aevised. No internal control system can be effective without such plan of organisation.

ii. A scientific system of authorisation and record procedure should be developed with a view to provide proper control over assets, liabilities, revenue and expenses of the organisation. It should be developed in such *a* fashion as to ensure that a) assets are under proper custody and they are not improperly applied, b) expenditures are incurred on getting proper authorisation and c) revenues received are duly accounted for.

iii. A system of healthy practices and traditions should be developed with a view to discharge the duties and functions of the various departments of the organisation smoothly.

iv. Since internal control system is to be exercised by the personnel employed in the organisation, there should be a team of people with sound character and integrity who are properly trained and capable of discharging their responsibilities.

v Constant managerial supervision and periodical review of the system should be introduced with a view to make the system more efficient and effective.

1. Check Your Progress

1. Define internal control

2. Distinguish between accounting control and administrative control.

3. State whether each of the following is true or false:

   a) Internal control is different from internal check.

   b) Internal control does not include accounting control

   c) Internal control is compulsory in all business organisation

   d Internal control include quality control and time and motion studies.

   e) An effective internal control system helps external auditor to design suitable audit.

5.5 INTERNAL AUDIT

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation.

The term internal audit has been defined as "an independent appraisal of activity" within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.

According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management."

The overall objective of internal auditing, therefore, is to assist the management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. **In short internal audit assures the management that the system of internal check and other types of controls are effective in design and operation.**

Thus, internal audit is a thorough examination of the accounting transactions to ensure that-

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

In modern times, an internal auditor carries a new task. The traditional function of checking the arithmetical correctness of the accounts with the help of vouchers and documents and verification of few items such as stock, cash and fixed assets is not sufficient. The duty of internal auditor now is to chart the procedure, examine the efficiency and work on programs of improvement of assessing the effectiveness of controls. He is expected to plan and arrange his task for effective functioning, set clear objectives of his own section, phase his objectives, gain the confidence of the management and demonstrate the value of his functions in areas of performance.

The internal audit is carried out generally in the same manner as is followed for a professional audit. However, it varies in form from enterprise to enterprise according to its size and specific needs. It is installed in large organisation and is carried out by the salaried staff who are qualified to conduct professional audit. Being the employee of the organisation he has to ensure that there is no waste in the organisation. Internal auditor has to follow the provisions of law, standard auditing practices and procedure prescribed for professional auditors and by the professional bodies controlling the audit system in the country. At the same time internal auditor must be aware of the policies and programs of the enterprise he should be professionally competent to carry out a detailed examination of the working of the business. Equipped with professional expertise and knowledge of the business, he will be in a better position to make the internal audit system more effective.

5.5.1 Objectives of internal audit

The main objectives of internal audit are as under:-

- To verify the correctness and authenticity of the financial records and statistical records presented to the management.
- To ensure that the standard accounting practices are strictly followed in the organisation.
- To facilitate early detection of errors and frauds.
- To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.
- To review the system of internal check from time to time to advice the management on improvement of the system and to undertake special investigation for the management.
- To confirm that the liabilities have been incurred by the organisation for legitimate activities.

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

5.5.2 Internal audit v/s statutory audit

Internal audit helps the statutory audit to a large extent. Both the internal auditor and the statutory auditor have a common interest as far as authenticity of the accounts are concerned. However soundness of internal audit relieves the statutory auditor from detailed checking.

The internal auditor reviews the operations and performs such functions as evaluation, compliance, verification and ensures that policies, procedures, rules and other type of controls of the business are carried out efficiently.

He is helpful to statutory auditor in the matter of examination of books of accounts. Generally, the statutory auditor accepts some of the detailed checking made by the internal auditor. However, the area of co-operation between internal auditor and statutory auditor is somewhat limited as the statutory auditor has a responsibility under law to various authorities, while the internal auditor is responsible only to the management. The statutory auditor has to carry out his duties in accordance with standard accounting and auditing practices and provisions of law which govern the organisation. Before accepting the checking of accounts and other documents carried out by internal auditor, the statutory auditor must undertake such test checks necessary to find out the effectiveness of internal audit.

Both internal auditor and statutory auditor carry out examination of records and documents and make physical and other verifications. Despite these similarities there are differences in the status, responsibilities, approach and scope of work of internal auditor and statutory auditor.

Differences between internal audit and statutory audit-

The following are the points of differences between internal audit and statutory audit:

Internal audit	**Statutory audit**
1. Internal audit is the arrangement within the organisation to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff.	Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.
2. Internal audit is not compulsory.	Statutory audit is compulsory in case of business houses incorporated under the Companies Act and other acts.
3. Internal audit is carried out by the staff appointed by the business enterprises. It is not necessary that the internal audit staff should possess the qualification prescribed for professional auditor	Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other acts.
4. Being an employee of the organisation internal auditor is answerable to the management. His duties, responsibilities etc. regarding	The rights, duties, responsibilities and liabilities of auditors are governed by the provisions of law. The auditor is independent of management.

audit work are determined by the management. The management can increase the powers and authority of the internal auditor. Similarly it can also curtail his powers.	
5. The internal auditor points out irregularities in the procedural aspects and suggests ways and means to rectify the same. He assures that the financial operations and other types of control in force are carried out in conformity with the accounting systems.	The statutory auditor is concerned with the legality and validity of the transactions of business. His audit work is based on the financial statement prepared by the business.

5.6 INTERNAL CHECK

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Spicer and Pegler have defined a system of internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons., fraud is prevented and at the same time possibilities of errors are reduced to a minimum". De Paula has defined internal check as "a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff."

Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.

The essential elements of internal check are as under-

- Existence of checks on day to day transactions.
- The check is to be carried out continuously as a part of the routine system.
- The work is divided among the staff and each staff is assigned a specific task.
- The work of each staff though independent is complementary to the work of another.

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

5.6.1 Objectives of internal check

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.
- To detect fraud and errors easily and correct them promptly.
- To exercise moral pressure among the members of the staff.
- To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.
- To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

- To have an accurate and reliable record of all business transactions.

Essentials of good internal check system

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

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

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

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

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

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

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

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

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

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

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

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

5.6.2 Internal check as regard cash sales

Since chances of committing fraud in connection with cash sales are greater, it calls for devising an efficient and effective system of internal check. Cash sales may be affected in various ways like a) sale at counter, b) postal sales, i.e. sales under mail order, and c) sales by representative and agents. The system of internal check to be followed in each case is discussed below.

- One salesman should be appointed to look after one counter independently and should be made responsible for sales effected in his counter.

- Each salesman must be issued with a separate cash memo book. The cash memo book must be printed in different colours to identify different counters of the business.

- Each salesman must maintain a sales sheet. He should record therein the sales effected by him. The summary of cash sales effected by him must tally with the cash memos issued by him.

- Cash memos are to be issued with carbon copies.

- The salesman must not receive cash on the cash memos issued by him.

- All payments on the cash memo of the salesman must be made by the customer at the cash counter.

Sales are to be effected in the following manner

1. Three copies of the cash memo must be issued to customer

2. The customer must present the three copies of cash memo to the cashier at the time of making payment

3. The cashier must verify the particulars and satisfy himself regarding the total payment with reference to rates and quantity.

4. The cashier on receiving the payment in cash will place a rubber stamp on all the copies of memos as "cash paid".

5. He will retain one copy with himself and hand over the other two copies to the customer.

6. The customer must present the cash memos to the delivery department to collect the goods purchased.

7. The delivery department will put rubber stamp on the memos as "goods delivered". It will retain one copy as an evidence for delivery and hand over another copy of the memo to the customer.

At the end of the day's working, the sales man, the cashier and the gate keeper should prepare the summary and submit to the manager or officer incharge. If these summaries tally, the accounts are certified as correct.

Postal sales i.e. sales under mail order

This includes following aspects:

- All sales made by post i.e. V.P.P should be recorded in a separate register to be maintained for the purpose.
- The goods returned, if any, should also be recorded in the register.
- The total amount of cash receipts including advance, if any, against the mail orders should be entered in the register and the same should be deposited into the bank.
- All the entries in the V.P.P. register should be checked by some responsible officer and special inquiries should be made in respect of those goods against which cash has not been received.
- There should be proper filing of mail orders received and the cash book should be checked with these mail orders.

Sales by representative and agents

It is the practice in big business houses to employ representative and agent to promote sales and to collect the amount due from debtors. The system of internal check to be introduced in this connection should be as follows:

1. The representatives and agents should be authorised to issue rough receipts to the customers against cash received from them. However, the final receipt should be issued only by the head office.
2. The customers should be advised to communicate directly with the head office if they do not get the final receipt within a reasonable time period.

3. The representatives and agents should be instructed to remit the amount of cash collected by them to the head office without any delay.

4. The representatives and agents must not be allowed under any circumstances to deduct their commission or any other expenditure from the amount of cash collected by them. The bill for commission and other expenses should be submitted to the head office.

5. As a matter of routine the head office should send periodical statements of accounts to the customer with a view to apprise them of the latest position.

6. The representatives and agents should be advised to submit periodical statements to the head office showing therein the amount of sales made by them, the amount of cash collected by them and the names of the defaulters.

7. The head office should issue reminders to those defaulting customers who have failed to clear their dues.

8 The representatives and agents must not be allowed to operate from a fixed place. On the contrary, they should be transferred from time to time to other place in order to increase their efficiency and to avoid the possibility of committing fraud.

5.6.3 Internal check as regards purchases

Since chances of committing fraud in connection with the purchases of goods by a big business house are greater, it calls for devising an efficient and effective control system of internal check. In this connection one should be familiar with the purchases procedure which should be as under.

- The department requiring the material should fill in the purchase requisition indicating the quantity and quality to the purchase department.

- The purchase department on the basis of the requisition will send out enquiries to the various suppliers asking for quotation.

- On receipt of quotations the order will be placed on the best vendor taking into account the quality, period of delivery, competitive prices etc.

- On receiving the order the vendor shall execute the order. The supplies will be received by the stores department.

- On receipt of goods it will be verified with reference to the order with the goods received memo issued by the stores department. If the supplies are made according to the order the delivery note and invoice sent by the supplier will be forwarded to accounts department with endorsements for the goods received and taken to stores.

- The invoice will be passed for payment by a senior officer after verifying the terms and conditions of the supply with reference to rates and quality and other expenses detailed.

Keeping the above points in view, the following system of internal check is suggested with regards to purchase:

- There should be separate purchase department.

- Purchase order are to be issued only against indents received from the various department of the business.

- All orders should be a placed in writing. The order form must be preferably a printed form containing full details.

- The orders must be made in quadruplicate. One copy of the order is to be sent to the supplier. The second copy is to be sent to the concerned department which has placed the indent for supply; third copy is to be sent to account sdepartment and the fourth copy is to be retained by the purchase department for future reference.

- All orders for purchase, should be signed only by the purchase manager or the person authorised for this purpose.

- All orders should contain the seal of office.

- The goods received should be inspected with the copy of the order.

- The goods received are to be examined with delivery notes and supply invoices of the seller regarding quantity, quality and rates.

- The purchase department should make an endorsement putting rubber stamp on the suppliers bill with reference to goods received.

- After inspection and examination 'Goods Received Note' is to be prepared for each lot of purchase. The inspection note should also be attached to it.

- Endorsement must be made by the purchase manager or the authorised official (of stores department to take the goods into stock.

- The stores department should acknowledge receipt of goods and send the same to the order department.

- All packages of incoming goods are to be opened only in the presence of a responsible official.

- The stores officer on verification of the correctness of the goods received should enter them in the stock register.

- Generally a rubber stamp containing the following certificate will be placed on the suppliers bill and signed by the purchase manager

  "Certified that goods are received as per Order

  No,..........Dated..........and taken to stock vide Folio No,............ of stock register No,..........."

- The Payment on purchases must be made only after accounts department verifies the invoice, goods received note and purchase order.

- The accounts department should impress a rubber stamp on invoices which are passed for payment.

- A separate purchase register is to be maintained by the purchase department

- Ledger clerk should have no access to physical stock register or cash to avoid manipulation of accounts.

- For inter-branch purchase or inter-company purchases transfer notes should be issued.

- All Purchases that are made by employee for the personal use must be accounted for separately.

- A separate return outward book is to be maintained to record the return of goods to suppliers.

- Credit notes are to be issued for adjusting claims. The purchase department should send a copy of credit note to accounts department.

- A purchase ledger control account is to be maintained. Ledger account should be checked periodically against the suppliers statements.

- A perpetual inventory control method should be adopted to avoid excess quantity and to maintain minimum quantity.

- Where goods are delivered directly to locations or place of work not controlled by the purchase department, the invoices are to be passed by the purchase department only after examining the certificate of receipt of stock from the authority to whom the goods are delivered.

In general the purchase department must place purchase orders on the basis of indents, record the order in the purchase day book, enter the goods received in the goods inward book and send the invoice of the supplier alongwith the inspection report and goods received notes to the accounts department for payment.

Internal check as suggested above will avoid irregularities in purchase and minimize, if not completely eliminate, manipulation of accounts by entering fictitious purchase or entering invoice twice or mis-appropriating the discount or commission allowed by the suppliers.

5.6.4 Internal Check as regards Sales

The organisation of the sales department depends on the system of selling and distribution of goods. Unless the department is organised properly there are greater possibilities for suppression of sales and manipulation of accounts. Goods can also be misappropriated. Hence, *a* well-knit system of internal check is necessary which may be in the following manner::

1) Sales must be executed against order received from customers.

2) All incoming orders shall be numbered and filled and confirmation of the orders received be sent to the customers.

3) Proper record is to be maintained for the orders received, order under execution/executed/refused.

4) The sales shall be authorised by responsible officials after scrutiny of the order and assessing the portion of supply of goods as well as the terms and conditions of sales accepted by the customer.

5) All sales orders shall contain invoices prepared in quadruplicate. One copy is to be retained by the sales department, one to be sent to the customer, one to the accounts department and the last copy to despatch section for despatch of goods.

6) Separate departments should deal with cash sales and credit sales.

7) In the case of credit sales a separate register should be maintained of the customers with financial standing. The credit sale is to be allowed only after scrutiny of the customer's order for supply of goods on credit.

8) Periodical statement of the outstanding balance due towards the customer be sent and confirmation obtained from them.

9) Regular reminders for payment shall be made to the customers reminding them of their dues.

10) Amount due from the customer shall be written off as bad unless all methods of recovery are exhausted.

11) The responsible official shall be entitled to treat a debt as bad.

12) The sales invoice clerk shall have no access to physical stock or accounting records.

13) The credit note shall be prepared only after ascertaining the fact from the despatch section and the sales department for the goods received back from the customers. Credit notes are to be prepared in quadruplicate. One is to be retained with the invoice department, second copy is to be sent to despatch department, third copy to the sales department and fourth copy to the customer.

14) In case sales are cancelled, a notice is to be given to the despatch department to stop despatch of goods.

15) The invoice can be cancelled only by the sales department. All sales invoices must be printed and numbered in serial order.

16) The sales ledger shall be maintained by a separate clerk.

17) Periodical statements should be sent to debtors.

18) In the case of credit sales regular confirmation should be obtained from the customers regarding the outstanding balances. The confirmation of balances must be verified by a senior person other than the ledger clerk.

19) A sales ledger control account shall be balanced with the control account periodically.

20) A sales ledger control account in the general ledger shall be maintained.

21) Credit to employees can be allowed only after proper authorization from the management.

22) Separate department should be set up to deal with sales on consignment, hire purchase, goods on sales or return etc.

23) The stock held by the agents should be verified periodically with the statements received from the agents.

24) The goods sent on sale or return basis but unsold on the date of the balance sheet should not be treated as sales but unsold stock.

Internal check system with regards cash received on sales is suggested under the caption "cash sales". The internal check of the sales department included the suggestions given for internal check on cash sales.

5.6.5 Internal Check as regards Wage Payment

In big organization, the work regarding the maintenance of various type of wage records, computing the amount of wages and the payment of wages to the right persons are of significant importance. It is, therefore, necessary to design a proper system of internal check regarding wages payment to minimize the dangers of fictitious names, errors in wages records and misappropriation of money. The following system of internal check is suggested:

1) Workers should be employed only after the written order of the Personnel Officer or the appointing authority. A copy of the appointment order be endorsed to the wage preparing section.

2) Separate staff should record attendance of workers, control of leave, payment of overtime and disbursement of pay packets. Each staff member shall be responsible to enter relevant information in the wage sheet. He should also put initials for the work completed by him.

3) The wage sheet shall contain columns for recording relevant information with regard to payment of wages such as name of the employee, designation, period for which wages are paid, rate of pay,

amount of basic pay, dearness allowance, house rent allowance, compensatory allowance and other allowance, gross salary drawn, deductions (there should be separate columns indicating the nature of deductions) and net amount payable and signature of employees, for acknowledging the payment.

4) Separate records should be maintained for each worker indicating the date of appointment, scale of pay, rate of pay, etc. Copies of orders relating to increase in pay, promotions and punishments, deduction in wages on account of Provident Fund, Loan, Medical, Ground Insurance etc. shall be endorsed to wage preparing section.

5) Separate job cards are to be maintained for recording the work performed by the worker.

6) Each worker is to be given a pay slip indicating the gross wages and net wages.

7) Separate register is to be maintained for recording the name of workers who may be allowed to work overtime. No worker shall be allowed to work overtime without the prior sanction of the proper authority.

8) Time recording clocks shall be installed at the main gate of the factory for recording the arrival and departure of workers.

9) The rosters of workers for each work should be prepared and copy of the same be sent to the wage preparing section.

10) Late arrival of workers shall be entered in a separate register and the same be sent to the personnel section for future reference.

11) Proper watch and ward arrangement is to be maintained to record the arrival of the workers and the time of leaving the factory.

12) The rate of wages of each worker is to be periodically checked with reference to rate card.

13) All calculations regarding gross wages and net wages payable after deduction are to be checked by an independent person.

14) In the wage sheet the names of workers, rates of pay, the period for wage to be paid shall be entered by one person. The calculations regarding gross wages payable shall be made by another person. The deductions under various heads shall be made by a third person. The net wages payable and the checking of the wages sheet with reference to leave deductions etc. should be made by a senior staff member. The wages sheet shall be signed by the authorised official.

15) If the wages are to be paid on the basis of piece wage system, the actual work done by each worker must be maintained on a job card to be given to each worker. These cards should be counter signed by the foreman of the department and the store department to which the goods produced are delivered.

16) The wage sheet shall be prepared in triplicate. One copy shall be endorsed to pay master, the second copy to the account section and final copy shall be retained by the wage preparing section.

5.6.6 Internal check system and auditor

The soundness of the system of internal check and the way it is put into operation in the organisation are matter of great importance for the auditor. In case the system of internal check is effective the work of the external auditor becomes quite easy. He is relieved of the detailed and routine checking of the transaction as the internal check system takes care of the same. In case the internal check system is not effective, then the auditor should have to decide the extent of detailed checking to be undertaken in order to satisfy himself about the authenticity of the business records. It is, therefore, necessary for the auditor to study the system in force in the organisation; this he can do by applying few test checks and if the results are satisfactory he can depend on the internal check system. In case the internal check system in force is weak or defective then he should carry out detailed checking of the accounting records. In case he does not do so he may be held liable for all the undetected errors and frauds. He should not show any negligence in his duty. He should design the audit program keeping in view the weak links of the system. He should also suggest the changes to the management strengthening the system of internal check. It should be noted that the existence of a sound internal check system in an organisation helps the auditor to a great extent in audit work, but does not reduce his legal liability at all.

5.6.7 Distinguish between internal check and internal control

Ans. Point	**Internal check**	**Internal control**
1. Meaning	It is a system of allocation of responsibility, division of work and methods of recording transactions, whereby the work of one employee is checked continuously by another.	It is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records.
2. Relation	It is a part of Internal Control.	It includes Internal check and Internal audit.
3. Essence	It is arrangement of book-keeping and Olerical duties.	It includes the essence of Internal check and internal audit.
	Checks are automatic and continuous.	It includes the implementation of Internal check and Internal audit.
		It includes Internal check and Internal audit.

4.How are they implemented.	Checks are objective.	
5. Nature		

5.6.8 Audit in respect of computer environment (E.D.P. audit).

The principal object of the audit is to ensure that the accounts on which the auditor is reporting show a true and fair view of the state of affairs at a given date and of the results for the period ended on that date. The essential features of an audit appropriate for medium or large sized concerns are :-

a) An evaluation of the system of accounting and internal control to ascertain whether they are appropriate for the business and properly record all transactions

b) The making of such tests and enquiries as are considered necessary to determine whether the systems are being operated correctly.

c) An examination of account in order to verify :-

i) The title, existence and value of the assets appearing in the balance sheet and to verify that all liabilities are correctly included therein.
ii) That the result shown by the profit and loss account is fairly stated.

And to ensure that such accounts are in accordance with the underlying records and comply with the appropriate statutory requirements.

The overall scope and objective of an audit does not change in an E.D.P. environment. However, the use of a computer changes the processing and storage of financial information and may effect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment.

The prime objective of EDP audit is to determine whether computer system safeguard assets, maintain data integrity, achieve organizational goals effectively and consume resources efficiently. A proper system of internal control is necessary to ensure that the objectives are met. It may be remembered that the overall objectives and scope of an audit does not change in an EDP environment. However, the use of a computer changes the processing and storage of financial information and may affect the organisation and procedure employed by the entity to achieve adequate internal control.

The auditor should take the following steps in addition to the normal audit procedure while auditing the computerised accounts.

1) Computerised accounting involves the code list for various types of accounts. The auditor should obtain the list of such codes and ensure that they are correctly used.

2) In manual accounting procedure each and every stage of recording the transactions is visible viz Preparing vouchers, passing entry, posting in ledger, casting, balancing, grouping, pre-paration of trial balance and final accounts. However, when the accounts are computerised it is not possible for the auditor to check each and every stage of recording the transactions as every thing is done by the computer behind the screen. Therefore, in such a situation it becomes necessary for the auditor to ensure that the functioning of the computer is correct and reliable. For this purpose he should select a sample of some transactions for processing and should compare the results obtained through computer processing with predetermined result.

3) In case of computerised accounts, the records of transactions are stored on floppy disks as back up data. These disks are affected by

heat, dust etc. The auditor should ensure that proper precautions have been taken by the client for the safe custody of such disks.

4) He should ensure that client has made a proper arrangement for protecting the computer data from "Virus".

5) He should ensure that there is proper control over the use of computers by the various users through "Passwords"

6) He should ensure that there is proper maintenance of computers by doing servicing at regular intervals. This will reduce the chances of break down and losses of records.

7) The accuracy of computer output depends upon the correctness of input. He should ensure that there is a proper system for checking of the output with the inputs on a regular basis.

8) Lastly, he should ensure that changes in software programs are carried out by authorised person only and such changes are property noted for future reference.

5.7 INTERNAL CONTROL

MEANING & PURPOSE

Control is a basic human requirement and it has existed throughout the ages in different facets of human activity. Business as such is a complex process and has grown even more complex with the technological advancement of the society. The formalization of the concept of internal control in the sphere of business administration is a comparatively recent phenomenon.

In the sphere of a business, control is an accepted device for optimum utilization of the resources and opportunities for maximisation of profits. All operations of a business are carried on with the help of human agents and equipment; both these factors need supervision so that the tasks assigned to them are properly carried out and avoidable wastes and losses do not occur to eat up the fruit of the enterprises.

The internal control required by a sole proprietor of small business is not identical with that required for a large industrial organization. A small trader having a grocery shop hardly needs more than one or two assistants. He decides work to be done by the assistants. He always knows his own stock, cash and bank position. He has the knowledge of daily sales. He himself knows the sources for purchases. He keeps the record of the debtors and creditors. The assistants merely help him in delivering doors to customers or to arrange the goods in proper order.

From the above, it can be observed that control is entirely centralized with the owner and there is no significant delegation of duties. However, as the business grows in size it soon reaches a stage where the owner can no longer keep himself intimately informed about the detailed operations of his business, activities of the employee and their discharge of their responsibilities. To cope with the increasing size and volume of business, he has to employ more and more people and for systematically carrying on the business, he has to specify the tasks for each person. For remote operations he has also to rely upon these people, for carrying out the work, for the custody of the materials, documents and equipments entrusted to them. He has also to ensure that the equipment and facilities are properly maintained. For this purpose, he has to give shape to a form of organization from which he would be in a position to know the board details of the work involved and the persons responsible for such work. Also, he has to work out a plan of delegation of duties and authority for the simple reason that, for anything and everything. People need not come to him for advice or decision, because, under such circumstances, he would not be able to find time to apply his mind to matters of more importance.

Human behavior is such that if it is not under some sort of regulation or control, it often tends to depart from the proper path. It needs to be kept under systematic watch not only for ensuring that the employee does he work, but also to see that he does it in the manner laid down for the purpose and handles the materials and equipments with proper care.

REVIEW OF INTERNAL CONTROL

A review of internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organization charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulative of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(1) Narrative record;

(2) Check list;

(3) Questionnaire; and

(4) Flow chart;

(1) The narrative record is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a system is in operation and would be more suitaed to small business. The basic disadvantages of narrative records are:

1. To comprehend the system is operation is quit difficult.

2. To identify weaknesses or gaps in the system

3. To incorporate charges arising on account of reshuffling of manpower, etc.

(2) A check list is a series of instruction and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instruction are usually Yes, No or Not applicable. This is again an on the job requirement and instructions are framed having regard to the desirable element of control. A few examples of check list instruction are given hereunder:

1. Are tenders called before placing orders?

2. Are the purchases made on the basis of a written order?

3. Is the purchase order form standardized?

4. Are purchase order forms are pre-numbered?

5. Are the stock control accounts maintained by persons who have nothing to do with:

(1) Custody of work;

(2) Receipt of stock;

(3) Inspection of stock; and

(4) Purchase of stock?

The complete check list is studied by the principle/manager/senior to ascertain existence of internal control and evaluate its implementation and efficiency.

(3) Internal control questionnaire is a comprehensive series of questions concerning internal control. This is the most widely used from for collecting information about the existence, operation and efficiency of internal control in an organization.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review the detail. In the questionnaire, generally questions are so framed that a ‘Yes’ answer denotes satisfactory position and a ‘No’ answer suggests weakness. Provision is made for an explanation or further details of ‘No’ answers. In respect of questions not relevant to the business, ’Not applicable’ reply is given.

The questionnaire is annually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor’s staff with the client employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendation for improvement.

(4) A flow chart is a graphical presentation of each part of the company’s system of internal control. A flow chart is considered to be the most concise way of recording the auditor’s review of the system. It minimises the amount of narrative explanation and thereby achieves and consideration or presentation not possible in any other form. It gives bird’s eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern: the nature of its activities and various channels of goods and materials as well as cash, both inward and outward, : and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

ADVANTAGES

Auditors' right to rely on Internal Control: The duty of safeguarding the assets of a Company is primarily that of the Management and the Auditor is entitled to rely upon the safeguards and Internal Controls instituted by the Management, although he will, of course, take into account any deficiencies he may find therein while drafting his Programme.

Audit Assurance: The Auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has infact been recorded. -

Integral part of Audit Programme: The examination and evaluation of the Internal Control System is an indispensable part of the overall Audit Programme.

Audit Planning: The Auditor should gain an understanding of the accounting system and related Internal Controls and should study and evaluate the operations of these Internal Controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Role of review: The review of Internal Controls will enable the Auditor to know –

(a) Whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(b) Whether an adequate Internal Control System is in use and operating as planned by the Management;

(c) Whether an effective Internal Audit department is operating;

(d) Whether any administrative control has a bearing on his work (e.g. when there is a weak control over

Worker recruitment and enrolment, there is a likelihood of including dummy names in the wages sheet which is relevant for the Auditor); fe) Whether the controls adequately safeguard the assets; *(f)* How far and how adequate is the Management effectively involved *ia* discharging its function of correct recording of transactions is concerned;

,'g) How reliable the reports, records and the certificates to the Management can be; (h) the extent and depth of the examination that he Auditor needs to carry out in the different areas of accounting;

(i) What would be the appropriate audit technique and audit procedure in the given circumstances; (/) what* are the areas where control is weak and where it is excessive; and (k) whether some worthwhile suggestions can be given to improve the control system.

(ii) **AUDITORS DUTIES**

Role of the Auditor vis-à-vis Internal Control can be summarized as under -

Management Responsibility: The duty of safeguarding assets of a Company is primarily that of Management. The Auditor is entitled to rely upon • safeguards and Internal Controls instituted by the Management.

Necessity for Evaluation: The Auditor is interested in ascertaining that transactions are executed in accordance with the Management's authorisation, all transactions are recorded properly and assets are adequately safeguarded. Therefore, the examination and evaluation of the Internal Control System is an indispensable part of the overall audit Programme.

Assurance: The Auditor needs reasonable assurance that the accounting system is adequate 1 .d that all the accounting information which should be recorded has in fact been recorded in a correct, proper and timely manner. Internal Control normally contributes to such assurance.

Audit Planning and Programme: The Auditor should gain an understanding of the accounting system and related Internal Controls. He should study and evaluate the operations of these Internal Controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. He can formulate his entire audit programme only after he has had a satisfactory understanding of the Internal Control System and its actual operation.

Review: If the Auditor reviews the Internal Control System of the client, he will be in a position to bring to the Management's notice, the weaknesses in the system and suggest measures for improvement. During the course of his audit, he may also ascertain how far the weaknesses have been removed.

Audit Procedure: Proper understanding of the Internal Control System enables the Auditor to decide upon appropriate audit procedure to be applied in different areas. In areas where Internal Control is considered weak, he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times may perform additional tests to gain necessary satisfaction.

Test Checking: In deciding upon a plan of selective checking (test checking or sample checking), the existence and operation of Internal Control System is of great significance.

Reporting: Under CARO, the Statutory Auditor of a Company has to report on the following aspectsrelating to Internal Control

(a) Is there an adequate Internal Control System commensurate with the size of the Company and the nature of its business, for the purchase of Inventory and Fixed Assets and for sale of goods and services?

(b) Whether there is a continuing failure to correct major weakness in **Internal Control System?**

A senior assistant of»X &:Co. Chartered Accountants dfevyupHjisiaudit Programme without! Evaluating the Internal Controls of T Ltd. When the Partner asked the reason, he stated that the' controls were developed by the General Manager (Finance) of T Ltd., who is also a Chartered Accountant and who had written a few books on subinterval Control" and therefore there, wqsjno reed to review foe said^qr«?o. State your viewpoints.

1. A proper understanding of the Internal Control System enables the Auditor to decide upon the nature, extent and timing of the appropriate substantive audit procedures ro be performed.

2. Although Internal Control is Management's responsibility, the Auditor-

(a) Should independently gain an understanding of the accounting system and related Internal Controls and

(b) Should study and evaluate the operation of those Internal Controls upon which he wishes to rely in determining the nature, timing and exient of other audit procedures.

3. Where the Auditor concludes that he can rely on certain Internal Controls, his substantive procedures would normally be less extensive than would otherwise be required. It may also differ as to their nature and timing.

4. Where Internal Control is weak, the Auditor might choose such an auditing procedure / test that might not be required otherwise. He might extend certain tests to cover a large number of transactions or other items than he otherwise would examine at times and perform additional tests for his satisfaction.

5. Just because the Internal Control was developed by a Chartered Accountant who had also authored a book on Internal Control is of no significance and does not absolve the Statutory Auditors' duties. The Auditor must independently understand and evaluate the Internal Controls to develop a proper audit Programme.

REVIEW OF INTERNAL CONTROLS

INHERENT LIMITATION OF INTERNAL CONTROL

Internal control can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because there are some inherent limitations of internal controls, such as:

(a) Management’s consideration that a control be cost effective;

(b) The fact that most controls do not tend to be directed at transactions of unusual nature;

(c) The potential for human error;

(d) The possibility of circumvention of controls through collusion with parties outside the entity or with employees of entity;

(e) The possibility that a person responsible for exercising control could abuse that authority, for example, a member of management overriding a control;

(f) The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate;

(g) Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

INTERNAL CONTROL SAMPLES FOR SALES & DEBTORS, PURCHASES & CREDITORS, WAGES & SALARIES

Sales and debtors

The primary Internal Control measures in relation to Sales & Debtors are -

j. All documents like Invoices, Delivery Challans, etc. should be serially numbered and missing documents promptly investigated.

Despatch, sales and invoicing functions are to be segregated.

Delivery Challan shall be verified by the carrier before dispatch.

4. Delivery Challan shall be verified with customer's Purchase Order before dispatch and serially filed.

5. Customers' acknowledgement for goods despatched must be promptly obtained.

6. Invoices prepared for all deliveries are to be sent to customers within a reasonable time.

7. Prices on invoices must be as per standard-price list and all unusual discounts / price reductions should be duly authorised.

8. Proper recording of returned goods should be made and Credit Notes duly authorised and verified with *j* related invoices.

9. Adequate records shall be maintained for part deliveries.

10. Listings in Sales Ledger balances shall be regularly balanced with Control Account.

11. Cheque received by post are to be recorded and bearer cheques must be stamped "A/c Payee only".

12. Record of receipts shall be duly verified with the bank pay-in-slip after deposit and also with the Cash Book.

13. Duties of personnel responsible for recording Sales Ledgers, receipts of cash and issue of receipts shall be segregated.

14. Cash takings/collections have to be matched with invoices.

J 5. Segregation of duties shall be defined between persons recording transactions and extracting balances.

16. Listings of Sales Ledger Balances shall be reconciled periodically with Control Accounts, by independent persons.

17. Ageing analysis shall be prepared and checked. Old balances should be followed up.

18. Statements shall be regularly sent, reconciliation with customer balances prepared at regular intervals and reconciling items shall be followed up.

19. Credit limits shall be checked before orders are accepted.

Important Internal Control measures in relation to Purchase & Creditors are -

Orders shall be supported by authorised requisitions and duly approved by a responsible official.

Tenders should be invited before placing orders.

Purchase orders have to be pre-numbered and serially controlled.

Goods Receiving Department should be adequately staffed to inspect, record and store goods received.

Goods Received Notes have to be pre-numbered and serially controlled.

The following duties should be segregated-

(a) Preparing Goods Received Notes;

(b) Recording goods received on Stock Records;

(c) Custody and authorizing issue of stores;

(d) Verification of Goods Received Notes with Invoices.

Invoices shall be verified with rates on Purchase Orders and calculations should be checked before posting.

Goods Received Notes lying unmatched with invoices shall be duly followed up and liabilities for goods

Received at year-end should be duly recorded.

Invoices should be recorded in an Invoice Register only upon receipt.

Suppliers' Statements shall be regularly reconciled.

Listings in Purchase Ledger Balance shall be reconciled periodically with the respective Control Accounts.

DISTINGUISH BETWEEN

INTERNAL CHECK	**INTERNAL CONTROL**
(1) Internal check means the arrangement of work different employees in such a manner that work of any person is automatically checked by another person is doing his duty.	(1) Internal control is the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.
(2) It on going continuous process.	(2) Internal control is a wider term which includes internal check, internal audit, etc.
(3) It is applicable to both, small & large organizations.	(3) Generally it is more applicable to large organizations where there are many departments.
(4)Relatively it is cheaper.	(4) Relatively setting up of internal control system is costly and time consuming.

INTERNAL TEST CHECK V/S INTERNAL CHECKS

PARTICULARS	TEST CHECK	INTERNAL CHECK
1. MEANING	it stands for the method of auditing when instead of a complete examination of all the transaction recorded in the books of account only some of the transaction are selected and verified.	It refers to a system of book-keeping and arrangement of staff duties in the organization in such a manner that no one person can completely carry through a transaction and record every aspect thereof.
2. INSTITUTED BY	It is an audit procedures performed by the auditor in respect of only selected group of transactions.	It is a series of procedures laid down by the management.
3.OBJECTIVE	The purpose is to aid auditors to check and draw conclusions about the voluminous transactions.	Its objective is to facilitate management functions.
4. FRAUD & ERRORS	It helps the auditor to unearth frauds and errors without checking all the transactions.	It is instituted to prevent frauds and errors.
5. MGMT CONTROL	Management has no control over the test checks carried out by the auditors.	Internal controls are subject to review, appraisal and changed by the management.

INTERNAL AUDIT

MEANING:

It is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. But internal audit must not be confused with internal check. Internal check consists of a set of rules or procedures that are part of the accounting system, introduced so as to ensures that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated. On the other hand, internal audit is a through examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the managements. However, the routine process by which an internal audit is carried out in broadly the same as those followed for professional audit. But internal audit often differs in its scope and emphasis: it is more managerial and accounting; also its form is varied, depending on the size of the organization. For instance, whereas a professional auditor is primarily concerned with the legality or validity of transactions entered into by a business an internal auditor in addition is expected to ensure that the standards of economy and efficiency are being maintained. On that accounts, the internal auditor must ascertain that orders for the purchase of stock are placed only after inviting tenders, sales are affected at the highest ruling rates, standard procedures as regards requirement of staff are followed, losses in manufacturing process suffered during the period under review are not higher than those in the earlier periods and so on. He must further confirm that there has been no leakage of stocks or of any other assets, reconciling the physical balance. The nature and extent of checking, that he should carry out, also would depend on the size and type of the business organization.

BASIC PRINCIPLES OF ESTABLISHING INTERNAL AUDIT

The basic principal of establishing internal audit in a business concern are-

1. Independence : the internal audit department should have an independent status in the organization. He may be required to report directly to the board of directors.

2. Objectives: the objectives of the internal audit function should be made very clear and unambiguous. The objectives should be properly communicated so that internal audit is not viewed as "over-the-shoulder check" by other departments.

3. Clarity in Scope: the scope pf internal audit department must be specified in a comprehensive manner. The department must at all times, have authority to investigated from the financial angle, every phase of organizational activity under any circumstances.

4. Definition of Duties: The internal audit Department's duty is to review operations as part of the internal control system. It should not be involved in performance of executive actions.

5. Internal Audit Department: The size and qualification of staff of the internal audit department should be commensurate with the size of the business. The cost of internal audit department should not exceed the benefits expected to be derived from it.

6. Reporting: The Programme of internal audit should be time-bound. There should be provisions for periodic reporting on various operational and other aspects.

7. Follow Up and Review: There should be sufficient scope for the follow up actions on the various points raised in internal audit report. Top management should take active part in ensuring compliance with actions points raised in the report.

8. Relationship with statutory auditor: The copy of the internal audit report should be made available to the statutory Auditor, who can deal with the same in the manner as he deems fit.

OBJECTIVES

(1) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.

(2) To ascertain that the standard accounting practices, as have been decided to be followed by the organization, are being adhered to.

(3) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.

(4) To confirm that liabilities have been incurred only for the legitimate activities of the organization.

.(5) To analyse and improve the system of internal check; in particular to see (1) that it is working;(2) that it is sound; and (3) that it is economical.

(6) To facilitate the prevention and detection of frauds.

(7) To examine the protection afforded to assets and the uses to which they are put.

(8) To make special investigation for management.

(9) To provide a channel whereby new ideas can be brought to the attention of management.

(10) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per SAP-7 The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its managements.

Normally, however, internal audit operates in one or more of the following areas:

(a) Review of accounting system and relating internal controls: the establishment of an adequate accounting system and related controls is the responsibility of managements which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.

(b) Examination for management of financial and operating information: This may include review of the means used to identify, measures, classify and report such information and specific inquiry into individual items including detailed testing of transaction, balances and procedures.

(c) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organization: Generally, the external auditor is interested in the results of such audit work only when it has an important reliability of the financial records.

(d) Physical examination and verification: The would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

EVALUATION OF INTERNAL AUDIT BY STATUTORY AUDITOR

USEFULNESS OF INTERNAL AUDIT

INTERNAL AUDIT V/S EXTERNAL AUDIT

(1) The role of internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and, thus , much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

(2) The external auditor should, as part of his audit, evaluate the internal audit function to the extent considers that it will be relevant in determining in nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluate, the external auditor may be adopt less extensive procedure than would otherwise be required.

(3) By its very nature, the internal audit function cannot be expected to have the some degree of independence as is essential when the external auditor expresses his opinion on the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he place’s on the internal work.

DISTINGUISH BETWEEN:

INTERNAL CHECK	INTERNAL AUDIT
(1) Internal check is not a specific check, but the duties of different persons are so arranged that a person's work is automatically checked by another person while carrying out the normal duty.	(1) Internal audit is specifically done to check that the accounts are properly maintained and the systems are in control.
(2) Internal check does the preventive job i.e. internal check is derived so that frauds and errors are prevented.	(2) Internal audit does the detective job of identifying frauds and errors and rectifying them.
(3) It is more of process in a day to day functioning of the business.	(3) It is specific defined job.
(4) All the persons in the organization are involved to maintain the internal check system.	(4) Specific persons are appointed to the internal audit.

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