



FREQUENT ASKED QUESTIONS IN AUDITING EXAMINATION FOR PCC

Q1) What do you understand by 'Auditing'? Explain its objectives, merits & demerits?

OR

"Accounting is a necessary, while auditing is not" Comment.

DEFINITION

Auditing is defined as

- The verification of accuracy and correctness of the books of accounts
- By a person qualified for the job
- And who is not in any way connected with the preparation of such accounts.

Auditing is an intelligent and a critical scrutiny of the books of accounts of a business with the documents and vouchers from which they have been written up.

According to A.W. Hanson: "An audit is an examination of such records to establish their reliability and authenticity of statements drawn from them."

We can sum up the above definitions as:

- (i) Auditing does not mean the preparation of accounts.
- (ii) Auditing implies scrutiny of the complete course of transaction in a business concern.
- (iii) Auditing does not ensure that accounts are free from errors and frauds.
- (iv) Auditing is only the verification of accounts by an independent person who examines and checks them and makes use of information and evidence available to him.
- (v) The auditor has not only to see the arithmetical accuracy of the books of accounts but also to go further and check that all the transactions are correctly entered in the books of accounts.

OBJECTIVES

The main objective of auditing is to form an independent judgment and opinion about the reliability of accounting records. The main purpose of auditing is the verification of financial statements, especially Balance Sheet and Profit and Loss account in the light of certain accounting principles to establish or not it is a true statement and correctly drawn up. The subsidiary objects of audit are:-

- Detection of errors.
- Detection of frauds.
- Prevention of frauds and errors.

ADVANTAGES

Auditing is not legally compulsory in all type of business. Still in those businesses where it is not compulsory, accounts are audited. This is because auditing of accounts gives certain advantages, which are as below:

- (1) It ensures the correctness of accounts.
- (2) It helps in detection of errors and frauds.
- (3) Audited accounts are more reliable and help the organization to grow.
- (4) Loans and credits can be easily obtained on the basis of audited accounts.
- (5) A business whose accounts are audited enjoys a better reputation
- (6) Audited accounts helps in the settlement of insurance claims.

- (7) Income tax authorities accept audited accounts for the purpose of taxation.
- (8) The management for the purpose of decision-making can safely rely upon audited accounts.
- (9) It helps to exercise moral check on directors and managers to Act honestly.
- (10) Audited accounts are taken to be more helpful in the settlement of accounts between the parties and thus avoid disputes.

DISADVANTAGES

Some businessmen think that auditing is wastage of time and money. It is merely a luxury. Auditing has lots of advantages, but the following arguments go against auditing:

- (1) Remuneration charged by the auditor is wastage of funds.
- (2) Formalities attached to auditing create difficulties for an average businessman.
- (3) It is not a foolproof method of detecting errors and frauds.
- (4) Audit obstructs the routine work of accounts.

Q2) What are the types of errors and frauds and what are the responsibilities of auditor attached to them.

The term "error" refers to unintentional mistakes in financial information whereas the term "fraud" refers to intentional misrepresentations of financial information.

TYPES OF ERRORS

- (i) **Clerical Errors:** These errors are committed in posting, totaling and balancing. Such errors may again be subdivided into:
 - (a) **Errors of Omission----** the errors of omission are one where a transaction has not been recorded in the books of account either wholly or partially
 - (b) **Errors of Commission----** when a transaction has been recorded but has been wrongly entered in the books.
- (ii) **Errors of Principle-----** Such errors arise when a business transaction is not recorded according to the basic principles of accounting.
- (iii) **Compensating Errors -----** If two or more errors are counter-balanced, (i.e. set off by one another) they will not effect the agreement of the Trial Balance.
- (iv) **Errors of Duplication-----** Such errors arise when an entry in a book of original entry has been made twice and has also been posted twice.

TYPES OF FRAUDS

Misappropriation of Cash---Such frauds are committed by any of the following methods:

- » Omitting to enter a cash receipt from customers
- » Acknowledging lesser amount than the actual receipt
- » Entering a fictitious payment
- » Entering larger expenditure than actually incurred.

Such misappropriation can be easily detected by comparing entries in the subsidiary books of accounts with their corresponding vouchers. Thus, there should be some efficient system of internal check in order to counter check the records maintained by cashier.

Misappropriation of Goods----This type of frauds is committed by stealing such goods, which are more valuable and less bulky. Chances of such misappropriate is at the issue of raw materials or at the sales and purchase counter or at godowns. In order to avoid and reduce chances of such misappropriation of goods, following steps should be taken:

- » To introduce effective system of internal check
- » To have proper check and records of inward and outward goods
- » To have vigilant watch at such places where the chances of stealing are greater

Misappropriation of accounts-----In order to conceal the true position of a business, proprietor or senior officers of the business concern may intentionally manipulate accounts. For instance, profits may be shown at higher or lower side. The purpose of such manipulation may be avoidance of Income-tax

Such frauds may take the form of

- (1) Recording fictitious purchases or Omission of purchase
- (2) Recording fictitious sales or Omission of expenses
- (3) Charging fictitious expenses or Omission of expenses
- (4) Charging over to lesser amount of provisions
- (5) Over or under valuation of assets or liabilities

Duties of auditor

Detection of fraud is considered to be one of the one of the important duties of an auditor. As a matter of fact, originally audit was conducted mainly with a view of detect fraud whenever it was suspected. The system of internal check aims at the prevention of fraud. If the auditor finds that the internal check system is defective and will not prevent the commission of frauds, he should suggest a better system. Frauds are difficult to be detected as they are committed by responsible persons and are also carefully guarded b them. Thus, considerable skill and vigilance of the auditor is required to detect them. An Auditor is unable to prevent errors and frauds completely. At the most he can put a moral check upon the employees of business concern by detecting the errors and frauds.

Q3) “An auditor is a watch dog and not a blood hound” Explain and illustrate this statement.

Ans. It has been observed in the case of Kingston Cotton Mills Co. (1896) case that an auditor is a watchdog and not a bloodhound. It is required that an auditor must be sufficiently careful and vigilant in respect of errors and frauds. But this does not mean that he should always be suspicious about the work of accountants, juniors and staff of his client, though he must always be very careful about the errors and frauds but he is not liable for the manipulation of accounts perpetrated by the trusted officials of this client. Thus, he is not expected to assume the role of a detective or a bloodhound. It is not proper that from the beginning he should adopt an attitude of mistrust. Of course he must not ignore the possibilities of frauds. During the course of audit he should be careful and have constant watch on the transactions of the business. Wherever there is any doubt, he should immediately probe the matter deeply and though while performing his duties, the auditor should never be afraid of displeasure of any one and losing of his own job.

Thus, the auditor should check the doubtful transactions without any fear and must report any discrepancy found out in the books of accounts.

DUTIES OF AN AUDITOR ARE AS FOLLOWS

- ☞ The auditor must discharge his functions faithfully with best of his skill, tact and care.
- ☞ He must be careful and intelligent in any enquiry.
- ☞ He must exercise reasonable care and skill in connection with detection of errors and frauds. Ordinarily he may not go into the details of minor and insignificant matters. But one he is suspicious of any error or fraud, he must carry out a thorough check to satisfy himself about the accuracy and truth of even most insignificant matters i.e. he must go for a detailed investigation.
- ☞ An auditor should always be on the alert to detect any error or fraud but he is not bound to be a detective. He should not always proceeds with a preconceived suspicion that there is something wrong. He is not to have such approach that the employees of his client are dishonest.
- ☞ The auditor should be faithful and honest towards his client and therefore must not take things for granted.

- ☞ From the auditor it is expected that he will use reasonable skill, care and caution in performing his duties. For the smooth audit work, his tact and experience will help him in securing proper cooperation from the members of staff of the business concern.
- ☞ Where the auditor has exercised reasonable care and have adopted sufficient skill in examining the accounting records to detect any error or fraud, he cannot be held liable for non-detection of the errors or frauds.

Q4) Discuss the rights, duties and liabilities of a company auditor?

The person who performs the functioning of auditing is an auditor. An auditor in order to perform his duties must have certain rights and powers without which he cannot perform his duties.

Rights of Company Auditor

In order to enable the auditor to discharge their duties without any difficulty several rights are conferred on him such as:

- ➔ **Right to access to the books of accounts (Section 227):** The auditor has the right of access the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere e.g. branch. The right of access to books, etc., is an absolute right and it is not subject to any restriction.
- ➔ **Right to call for information and explanation (Section 221) :** The auditor has the right to obtain any information and explanation from the directors or officers of the company. If not given then he has right to mention the same in the report to members that directors have refused to supply the information.
- ➔ **Right to inspect and audit branch accounts (Section 228)** If branch accounts are not audited the auditor has the right to visit and inspect the branch office. He also has the right to access to the books, accounts, vouchers and documents etc., maintained at the branch office.
- ➔ **Right to receive notices and attend general meetings (Section 231) :** The auditor has the right to receive notices and to other communications relating to any general meetings of the company. He also has right to attend any general meeting of the company.
- ➔ **Right to make statement at the general meeting:** The auditor has the right to make any statement or explanation that he desires and he is not bound to answer the questions of any shareholder unless they are directly connected with his work.
- ➔ **Right to seek legal and technical opinion from Experts** for the proper discharge of his duties at the expense of the company.
- ➔ **Right to make representation** of reasonable length in writing and to be heard in the general meeting when he is removed from his office.
- ➔ **Right to receive remuneration** after he has completed the work of auditing.
- ➔ **Right to sign the audit report (Sec. 209) -** The auditor has a right to sign the audit report or authenticate any other document required by law to be signed by auditor.
- ➔ **Right to be indemnified (Sec. 201) -** The auditor has a right to be indemnified against any liability incurred by him in defending any proceeding, whether civil or criminal, in which judgment is given in his favour.

DUTIES OF AUDITOR

1) STATUTORY DUTIES

(A) REPORT TO MEMBERS [SEC. 227 (2)] The auditor is required to make a report to the members of the company on the following matters

- Whether in his opinion the Profit and Loss Account shows a 'true and fair' view of the profit or loss.
- Whether in his opinion the Balance Sheet is properly drawn up so as to show a 'true and fair' view of the state of affairs of the business.

- c. Whether he has obtained all the information and explanations, which were necessary for the purpose of audit.
- d. Whether proper books of accounts as required by law have been maintained by the Company.
- e. Whether the report on the accounts of any branch office audited by a person other than the company's auditor has been forwarded to him and how he had dealt with the same in preparing the auditor's report.
- f. Whether the company's Balance sheet and Profit and Loss Account are in agreement with books of accounts and returns.

(B) DUTY AS TO INQUIRY SEC. 227(1-A) The following are the matters on which auditor has to make an inquiry

- a) **Loans and advances:** The auditor has to see whether loans and advances made by the company on the basis of security have been properly secured, and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.
- b) **Transactions represented merely by book entries:** He must see that transactions which are not supported by facts or evidence, though recorded in the books, are not prejudicial to the interest of the company.
- c) **Sale of investments at less than purchase price:** Where the company is not an investment company or a banking company, the auditor is required to see whether it has sold any shares, debentures or other securities at a price, which is lower than their purchase price.
- d) **Loans and advances shown as deposits:** He has to see whether loans and advances made by the company have not been shown as deposits, so as to avoid scrutiny by the members or others.
- e) **Personal expenses:** He should enquire whether any personal expenses have been charged to revenue accounts of the company, so as to improperly utilize the funds of the company for the individual benefit of any person directly or indirectly in control of the affairs of the company.
- f) **Allotment of shares for cash:** Where it is stated in the books and papers of the company that any shares have been allotted for cash, the auditor must enquire whether cash has actually been received in respect of such allotment, and if no cash has actually been received, whether the position as stated in the account books and the Balance Sheet is correct and regular.

(C) DUTY TO SIGN REPORT (SEC. 229) ---It is the duty, as well as right of the auditor to sign the report prepared by him.

(D) DUTY AS TO STATUTORY REPORT [SEC. 165(4)]---After the statutory report has been certified as correct by the required number of directors, the auditor of the company must certify it as correct to the extent it relates to:

- a. share allotted by the company;
- b. cash received in respect of such shares;
- c. receipts and payments of the company

2) DUTIES UNDER PROFESSIONAL ETIQUETTE

Following are some of the duties arising from professional etiquettes:

- a. An auditor is not to advertise or canvass, any body for getting business.
- b. An auditor is not to give any commission or share of his remuneration to any person for getting business.
- c. Before accepting his appointment in place of any retiring auditor he must communicate to know the reasons why the outgoing auditor was not reappointed and to know his objections if any.

LIABILITIES OF AN AUDITOR

In the case of companies the liabilities of auditors can be Civil liabilities and Criminal liabilities

THE CIVIL LIABILITIES of a company auditor can be for (i) negligence, (ii) misfeasance.

(1) Liability for negligence - A auditor performs his duties as an agent of the shareholders, so he is expected to safeguard the interests of his shareholders. He must exercise his reasonable care and diligence in the performance of his duties. If he fails to do so and in consequence the principal suffers any loss, he may be liable to compensate loss caused to the company resulting from his negligence.

(2) **Liability for Misfeasance** – Misfeasance means breach of duty or breach of trust. If the auditor does something wrongfully in the performance of his duties or he does not perform his duties properly resulting in a financial loss to the company, he may be held liable for misfeasance.

CRIMINAL LIABILITIES – The criminal liabilities of a company auditor under different sections of the Act are as follows: -

- (1) **Section 233** – If the auditor willfully makes a default in making his report to the shareholders according to the provisions of section 227 and 229, he will be punishable with fine, which may extend to Rs. 10,000.
- (2) **Section 240** – If the auditor fails to help an inspector appointed by the Central Govt. to investigate the affairs of the company, he is punishable with the imprisonment upto six months or with fine up to Rs. 20,000 or with both.
- (3) **Section 242** – When on the basis of the report of the inspector, Central Government prosecutes any person; the auditor is required to assist the prosecution. And if he fails to do so, he is punishable with imprisonment up to six months or with fine up to Rs. 5,000 or both.
- (4) **Section 477** – In the course of winding up of a company, the auditor is required to return to the court any documents in his possession. If the auditor fails to appear before the court, he can be arrested.
- (5) **Section 478** – On the application of the official liquidator the company auditor can be publicly examined in the High Court. The notes shall be taken down and be signed by the auditor. Such signed notes may be used in evidence against him in any civil or criminal proceedings.
- (6) **Section 539** – If the auditor is found guilty of destruction, alteration, falsification of any books, papers or securities, he can be held personally responsible. And if he makes any fraudulent entry in any register, books of accounts or documents of the company, he will be punishable with imprisonment up to 7 years and also be liable to fine.
- (7) **Section 545** – If the auditor is found to be guilty of any criminal offence during the course of winding up of the company, the liquidator can prosecute him.
- (8) **Section 628** – If the auditor makes a false statement in the returns, prospectus or other statements, etc. knowing it to be false or omits any material fact, he will be punishable with imprisonment upto 2 years and also be liable to fine.

Q5) State the provisions of Companies Act, 1956 regarding qualifications, disqualifications and appointment, reappointment, removal and remuneration of company auditors?

Qualifications of a Company Auditor

Sec. 224 of Indian Companies Act 1956 provides for the compulsory audit of companies accounts by a qualified auditor. Sec. 226 lays down minimum legal qualifications of any auditor for the audit of companies such as:

- Practicing Chartered Accounts or their firms. [Sec. 226(1)].
- Certified Auditors under the Restricted Auditors Certificate Rules 1956 [Sec. 226(2)].

The object of such qualifications is to make sure that only persons of discipline and standing are appointed as auditors.

Disqualifications of auditor

In order to maintain a reasonable standard of auditing profession so that his report is greatly relied upon the following persons are disqualified from being appointed as a company's auditor

Sec. 226(3).

- a) A body corporate.
- b) Any director, officer or employee of the company.
- c) A person who is a partner or who is in the employment of an officer or employee of the company.
- d) Any person indebted to the company for a sum more than Rs. 1,000/- or has given any guarantee or provided any security in connection with indebtedness of any third person to the company for a sum more than Rs. 1,000/-
- e) As insolvent or an insane person.
- f) If he holds appointment as auditor in the specified number of companies.

Appointment of Auditors

Appointment of first auditor [Sec. 224(5)]

The first auditor(s) of a company shall be appointed by the Board of directors within one month of the date of registration of the company. The auditor so appointed shall hold office until the conclusion of the first annual general meeting. Appointment of the first auditor should be by a valid resolution at the Board meeting. In case the Board does not exercise its power in this regard, the first auditor(s) shall be appointed by the company in its general meeting.

Appointment by company, i.e., shareholders [Sec. 224]

Section 224(1) empowers the shareholders to appoint auditor at each general meeting by passing a resolution. The auditor so appointed in a meeting hold office from the conclusion of that meeting till the conclusion of next annual general meeting. The company shall intimate every auditor so appointed within seven days of the appointment. The auditor so appointed shall within 30 days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted or refused to accept the appointment.

Reappointment of auditor [Sec. 224(3)]

Ordinarily, at any annual general meeting, the retiring auditor shall automatically be reappointed. Neither the Board nor the shareholders can refuse to reappoint him. However, in the following cases, the retiring auditor shall not be reappointed:

- a) if he is not qualified for reappointment.
- b) If he has given the company a notice in writing of his unwillingness to be reappointed.
- c) If a resolution has been passed at the meeting (a) to appoint somebody other than him, or (b) to provide expressly that he shall not be reappointed or
- d) If a notice has been given of any resolution proposing the appointment of some other person in the place of the retiring auditor.

Appointment by Central Government [Sec. 224 (3)]

Where at any general meeting, no auditor is appointed or reappointed, the Central Government may appoint a person to fill the vacancy. In such a case, the company is required, within seven days of its failure to appoint or reappoint an auditor to apply to Central Government. The said application must disclose in sufficient detail the reasons why the company could not appoint the auditor at its general meeting. In the case of default, the company and every officer of the company who is in default shall be punishable with a fine, which may extend to Rs. 5000 [Sec. 224(4)].

Appointment in case of casual vacancy [Sec. 224 (6)]

The Board of directors may fill any casual vacancy in the office of the auditor. Where any casual vacancy is caused by the resignation of an auditor during the term of his appointment, the vacancy shall only be filled by the company at the general meeting.

“Casual vacancy” means vacancy in the office of auditor resulting from accident or fortuitous circumstances such as death, incapacity or disqualification of the auditor. But it implies that the person who had been appointed to, and holding the office of auditor has ceased to continue as such.

Refusal of a person to accept his appointment or reappointment as auditor will not result in casual vacancy, and the Board has no power to fill such vacancy even if the shareholders have, at the time of appointing or reappointing the auditor but anticipating his refusal to accept such appointment, authorized the Board to fill the vacancy caused by such refusal. In such a case only the shareholders can fill the vacancy in the general meeting.

Remuneration of Auditor

The general rule is that the appointing authority is authorized to fix the remuneration of an auditor. According to the provisions of Sec. 224(8), the arrangement may be described as under:

- ➔ If the Board of Directors or the Central Government appoints an auditor, his remuneration is to be fixed by the Board or Central Government as the case may be.
- ➔ In other cases, the remuneration of the auditor shall be fixed by the company in General Meeting or in such a manner as the company in General Meeting determine.

Q6) Explain the meaning of “Continuous Audit”? What are the advantages and disadvantages of such an audit?

Continuous Audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular interval during the period. Thus, in case of continuous audit, the audit staff is present at the client's premises almost during the entire accounting period.

CONTINUOUS AUDIT IS APPLICABLE IN THE FOLLOWING CASES

- (1) Where the business is large, complex and involves numerous transactions.
- (2) Where the system of internal control and internal check are not satisfactory.
- (3) Where the management requires monthly or quarterly audited statements of accounts.
- (4) Where interim dividend is to be declared.
- (5) Where it is necessary to present the final account just at the closure of financial year, e.g., railway, banks etc.
- (6) Where cash transactions are more.
- (7) Where sales are very large and a detailed investigation is required.

ADVANTAGES OF CONTINUOUS AUDIT

The following are the main advantages of continuous audit:-

- (1) Errors are discovered earlier, hence there is adequate time for making the necessary rectifications.
- (2) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.
- (3) Frauds, if committed, are detected before they attain large proportions.
- (4) The attendance of the audit staff acts a moral check on the client's staff.
- (5) The client's accounts are always kept up-to-date.
- (6) It ensures quick preparation of accounts and the audit report.
- (7) The regular supervision by the auditor brings increased efficiency and accuracy in the accounts of the concern.
- (8) The proprietor of the concern may get any desired information duly verified at any time without any difficulty.

DISADVANTAGES OF CONTINUOUS AUDIT

- (1) Figures may be altered either innocently or fraudulently by the client's staff after the auditor has checked the books of a particular period.
- (2) The examination of an item left incomplete on a visit for being undertaken on the next visit may be overlooked.
- (3) It is costly as the auditor has to devote more time and therefore, the charges will be high which the small concerns cannot afford.
- (4) Continuous audit may disrupt the routine accounting work of the client.
- (5) Continuous visit to the client's place may make the work tedious and the audit staff loses interest from work consequently.

PRECAUTIONS TO REMOVE DRAWBACKS OF CONTINUOUS AUDIT

- (1) During the course of each visit, work should be completed up to a definite stage so as to avoid loose ends.
- (2) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.
- (3) The nominal accounts should be checked only at the time of final closing.
- (4) The auditor should give specific instructions to the client's staff not to make any alteration after the checking of books of accounts.
- (5) The auditor should prepare notes and checklists of each visit to avoid the alteration.
- (6) The auditor should pay surprise visits, so that the staff of the client may not be able to prepare themselves in advance for the same.

Q7) "Vouching is the essence of Auditing" Discuss.

Meaning of Voucher--Voucher is the original document in support of any payment or receipt of money pertaining to a transaction in a business. It forms the basis of accuracy of any entry in the books of accounts.

According to J.P. Batliboi "A voucher may be defined as a documentary evidence in support of an entry appearing in the books of accounts."

Meaning of Vouching----- 'Vouching' means a careful examination of the original documentary evidence such as invoices, receipts, statements, correspondence, minutes, contracts etc. in order to check the accuracy of records in the books of accounts. Thus, it is a mode of verifying the authenticity and correctness of entries in the books of accounts. Merely by checking the arithmetical accuracy of posting is no proof that all the transactions are correctly recorded. For instance, an entry may be recorded about a purchase from A but just this entry does not prove that the goods were actually received or misappropriate or the entry is entirely fictitious. Hence vouching is an important tool of auditing. It is indispensable as it helps to ascertain whether:

- The transaction is within the general nature of the business.
- The transaction has been duly authorized.
- The transaction has been correctly recorded in the books of accounts.

Objects of Vouching---Main object of vouching the payments is not only to find out that money has been duly paid but also to vouch payments for the following purposes.

- To verify that all transactions have been duly authorized.
- To check that there is no omission of any entry and all transactions relate to the period under audit.
- To check that all transaction and related to the nature of business and expenditures are proper business charge.
- To verify cash in hand and a Bank.
- To detect if there is any misappropriation of cash or goods.
- To see that the payments have been duly received by the correct payees.
- The vouching in support of the entries are legally valid with regard to its date, authority, related to business concern etc.

While vouching the auditor should note that:

- (a) It is cancelled by stamping so that it cannot be produced again
- (b) Not to take help of employees

- (c) Vouchers are related with the nature of business
- (d) Payment is duly posted, as per principles of accounting for instance whether it is capital or revenue expenditure.
- (e) If required, verify further with other documents like Memorandum of Association, Articles of Association, Prospectus, Partnership deed etc.
- (f) Missing vouchers should be carefully noted that brought to the knowledge of the owner of the business concern.
- (g) Details of each voucher should agree in total with their entries
- (h) Check that no payment has been made contrary to the terms and conditions of agreements
- (i) Check whether cash discounts etc. has been availed and proper adjustments has been made in the accounts.

Q8) What is internal check? Explain its object and features. Can an auditor can rely on internal check?

Internal Check---Internal checks relate to such an arrangement of accounting routine that errors and frauds are detected and prevented during the recording of business transactions. This is possible when every work is divided amongst different employees who are frequently transferred from one job to another. Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organization and job allocation aspects of the control system are concerned.

According to F.R.M. De paula – “An internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by the other members of the staff.”

According to W. Johnson “Internal Checks as one wherein the accounting work of one employee is complimented and verified by the work of another employee both employees working independently without duplication of each other’s work.”

Features of Internal checks are:

- ➔ Internal Check means the distribution of work amongst various employees in such a way that the work done by one is immediately checked by another as a part of regular routine.
- ➔ None is allowed to carry out a particular transaction from the beginning to the end. Such procedure ensures that errors and frauds cannot remain undetected unless there is collusion.
- ➔ This does not mean that frauds etc. cannot be committed, but its possibility is minimized and chances of detection are increased. It helps in unnecessary repetition in checking as the distribution of work is such that checking is done side by side.
- ➔ The clerk in charge of a book of prime entry should not have access to the ledger.
- ➔ Self-balancing ledger system, time recording clocks regarding wages or automatic fills for recording cash receipts are some of the devices by which the commission of fraud may be prevented.
- ➔ The work of the members of the staff should be changed from time to time.
- ➔ They should be encouraged to take leaves because errors and frauds can be detected easily in their absence.

Common Areas of Internal Check

- (i) A responsible official should be made responsible for receiving letters, etc. All important letters, registered envelopes and money orders should be entered in a proper register and then passed on to the clerks concerned.

- (ii) Purchase, receipt and issue of goods should always be done under strict supervision and control. No one should be permitted to take away any goods without proper sanction.
- (iii) Jobs relating to bad debts, allowances, returns, etc., should be performed under strict control.
- (iv) It should be seen that some responsible person is assigned the task of dealing and corresponding with the debtors and creditors of the business.
- (v) Important work like payment of wages, valuation of stock, sales, etc., should be done under strict supervision and control.
- (vi) An important control for cash receipts, payments and balances held should be made. Regular deposits of cash into bank and due safeguards should be exercised to avoid misappropriation of cash. Capital expenditure on fixed assets should be kept under strict check and supervision.
- (vii) Purchasing has to be done in a proper systematic manner to avoid any collusion with the supplier and thus preventing frauds.

Objectives of Internal Check

- To have accurate record of business by preventing errors and frauds.
- To fix responsibility for particular default or omission on a definite person
- To have confirmation of facts and entries of transactions
- To facilitate division of labour for the smooth flow of work

Advantages of Internal Check

- a) **Adequate subdivision and allocation of work:** An ideal system of internal check enables to subdivide the whole of work into small units which are allocated to different employees on the basis of each one's ability, training, qualifications, experience and field of specialization.
- b) **Early detection of errors and thus prevention of frauds:** In an efficient system of internal check, none is allowed to complete any job independently but the whole of job is divided among many workers. The work of each such employee is cross checked during the ordinary course of business, knowledge of such cross checking acts as a moral check to commit errors and frauds.
- c) **Efficient and economic functioning:** Proper allocation of work based on qualification, ability and specialization of each employee helps to promote efficiency in each department of the business concern. With such efficiency among the staff, there is over all economy in the operations of the business leading to higher profits.
- d) **Quick preparation of final statements:** Having efficient system of internal check, one can rely on the accounting records of the business concern. Thus the books of accounts can be used directly and quickly to prepare the final statements as there is no need to check the business transactions so thoroughly.
- e) **External Auditing not required:** Unless required under some rules and regulations, books and accounts of such business concerns need not be audited. Even when there is need to go for auditing, the efficient system of internal check enables auditor to avoid thorough checking of all the transactions. At the most, the auditor selects certain facts randomly to test the reliability of the internal check system.
- f) **Determination of Responsibility:** Since in the system of internal check the total work is divided and allocated among different employees, staff can be held responsible for any lapse or irregularity committed.

Disadvantages of Internal Check

- a) **Costly and time consuming:** Since the job of any type is divided into small unit, the process of completing the job is more costly and time consuming.

- b) **Not suitable for small business:** Being costly and time consuming the system of internal check cannot be introduced in small businesses.
- c) **Quality of work declines:** As single job is attended by many employees, quality of the work declines. Each employee does his part of job without taking care of the quality of the work as a whole.
- d) **High officials become lazy:** Being under the impression that an effective and efficient system of internal check has been introduced, the high officials do not supervise seriously. They presume that nothing can go wrong.
- e) **Causes groupism:** Since employees are not working independently and job of one is linked with another, they may join hands to commit and fraud. This way they can cause to fail the system of internal check altogether.
- f) **Auditor excessive reliability:** Since one of the purpose of system of Internal Check is to create reliability of books of accounts of the business concern, external auditors reliance without proper tests may create his liability for negligence.

Q9) Short notes

(1) DIVIDENDS AND DIVISIBLE PROFITS

Divisible profit is that part of actual profit of the company which has been earned and really exists for the distribution to the shareholders as dividends. The actual amount of divisible profits is determined in accordance with the provision of:

- Memorandum and Articles of Association
- Companies Act
- Principal of Accountancy

→ **Memorandum and Articles of Association:** The provision of these important documents of the company has to be considered for the ascertainment of divisible profits. These provisions have important bearing on the determination of the divisible profits.

→ **Provisions of the Companies Act:** For calculating divisible profits following items has to be considered:

✕ **Depreciation:** It is compulsory to debit depreciation before having divisible profits. However, Central Government may allow any company to pay dividend out of profits without providing for depreciation.

✕ **Past Losses:** A company may face such a situation to know whether current profits can be distributed without writing off the past losses. The Companies Act does not make it compulsory to provide for the past losses before distributing the current year profits for dividends. Of course, sound principles of accounting require that the past losses should be provided first in order to ascertain the divisible profits.

✕ **Capital Losses:** Such loss arises when an asset is sold for a value less than the Book value of the asset. Under such a situation, can the company declare dividend out of current year profits without writing off the capital loss? The Companies Act does not make it compulsory to provide for the capital losses before distributions of the current year profits as dividends. Of course sound principles of accounting require that the capital losses should be provided first to ascertain the divisible profits.

✕ **Capital Profits:** Such profits arise when an asset is sold for a value more than the Book value of the asset. Can a company distribute dividends from the capital profits? Companies Act does not prohibit the distribution of such capital profits as dividends though it has made provision to distribute in the form of bonus shares. But generally capital profits are not distributed as dividends for up keeping the sound principles of accounting.

Dividends can be declared and paid only out of current or accumulated profits of the company. Broadly the important factors which the director of company has to consider before recommending dividend can be divided as

- Provisions of Companies Act, 1956
- Provisions of Articles of Association of the Company.
- **Provisions of Companies Act:** Following are the important factors:

✗ **Dividend cannot be paid out of Capital** As per Sec. 100 of the Companies Act; dividend cannot be paid out of the capital but only out of the profits of the company. Thus, directors have to ascertain the divisible profits of the company.

✗ **Capital Profits:** Normally dividends are declared only out of revenue profits. Where there are certain compelling forces to declare dividend out of capital profits, the directors must ensure:

- (a) Articles of Association authorities to distribute such profits as dividend.
- (b) The capital profits have been realized in cash.
- (c) It is real surplus after revaluation of all assets and liabilities of the company.
- (d) All capital losses has been written off
- (e) The company is financially sound to pay off all its debts
- (f) The capital profit has not been transferred to Capital Reserve Account.

✗ **Revenue Profits:** Normally dividend is paid out of revenue profits. Before such payment is made, directors must ascertain that following provisions has been made:

- (a) Proper depreciation on fixed and floating assets has been provided.
- (b) Past losses has been written off
- (c) Prescribed rate of reserve has been provided.

✗ **Arrears of depreciation** and earlier losses have to be been written off.

✗ **Creation of certain funds:** Where the company has raised funds through the issue of debentures, sufficient profit has been transferred to Debenture Redemption Fund.

✗ **Payment has to be in Cash only:** As per Sec. 205(3), all dividends has to be paid in cash only. Therefore the directors must ensure that the company has or will have sufficient cash resources to pay off the dividends.

✗ **Payment within 42 days:** Dividends has to be paid within 42 days of its declaration in the general meeting of the company.

✗ All arrears of dividend including current year dividend must have been paid to the Cumulative Preference shareholders.

→ **Provisions of Articles of Association:** The regulations regarding dividend are:

- ✗ Rate of Dividend is recommended by Board of Directors and is payable after it is declared by general meeting of the Company. The members cannot exceed the recommended rate of dividend.
- ✗ Interim dividends can be declared and paid by the directors at any time during the year.
- ✗ Directors can appropriate the profits for creation of any reserve or fund prior to the declaration of dividend.
- ✗ Dividends are not to be distributed out of capital of the company.

(2) TYPES OF AUDIT REPORTS

Broadly the kinds of audit report can be classified as follows:

- A. According to Nature of work
- B. According to Opinion of auditor

According to Nature of work: It has the following kinds:

- 1) **Final Report:** An auditor submits a final report when the whole of the audit process is completed for a particular audit period of the business concern.
- 2) **Interim Report :** An auditor submits an interim report during the audit period on some specific matters like profits earned during a part of the year to declare interim dividend.
- 3) **Partial Report :** An auditor submits a partial report when he is assigned the job to audit only with limited scope or to examine only some particular books of accounts. The auditor is to make it clear in the scope of audit that he is appointed for the specific purpose and extend to which scope of his audit work is limited.

According to Opinion of auditor: The opinions expressed by the auditor may be classified as:

- 1) **Unqualified Opinion :** The auditor gives his unqualified or clear opinion when:
 - (a) He is convinced that the accounts are maintained in uniformity with accounting principles and legal requirement, and
 - (b) He has no doubt about the truth and fairness of Balance Sheet and Profit and Loss Account of the business concern.

Thus, giving unqualified opinion means that the auditor has no reservation or qualification or comment to make on the accounts and financial statement of the business concern.

- 2) **Qualified Opinion :** The auditor gives his qualified opinion or opinion with certain reservations when:

- (a) He is not convinced that the accounts are maintained in conformity with the accounting principles and legal requirements.
- (b) He has doubts about the truth and fairness of Balance Sheet or Profit and Loss Account of the business concern.

While issuing a qualified opinion, the auditor has to state subject to qualifications and reasons for the qualifications.

Such qualified report should be given only where the issue involved does not distort and significantly affect the presentation of financial statements of the business concern.

- 3) **Adverse or negative opinion:** The auditor gives adverse or negative opinion when:
 - (a) There is substantial departure from generally accepted principles of accounting in the preparation and maintenance of accounts.
 - (b) There is a material misstatement in the financial statements.
 - (c) There is an omission of a material disclosure.

Hence where the qualified opinion of the auditor is so material that merely by giving his opinions the purpose will not be served, the auditor has no alternative but to issue an adverse or negative report.

- 4) **Disclaimer :** The auditor may disclaim an opinion on the accounts, Balance Sheet and Profit and Loss Account when:

Auditor does not have sufficient information to form any opinion.
Auditor process is not adequate to form any opinion.
Some items are so much indeterminate that makes fair presentation of financial statements impossible.

Wherever the auditor is unable to express any opinion on the accounts of financial statement, he must give reasons for it.

(3) AUDIT WORKING PAPERS

Audit Working Papers are those papers, which contain essential facts about accounts so that the auditors may not have again to go over the accounts of his client in case he wants to refer to them later on during the course of his audit.

According to A.W. Johnson – “Audit working papers are the written, private materials, which an auditor prepares for each audit. They describe the accounting information which he received from his client, the methods of examinations used, his conclusions and the financial statements.”

Besides providing evidence of work performance, working papers are helpful for:

- (i) Supervision and review of audit work.
- (ii) Planning and performance of audit, etc.

Audit working papers includes the following:-

- (1) Audit Program
- (2) Audit Note Book
- (3) Copies of the documents, which the auditor has taken
- (4) Contract letters from the client
- (5) Copies of previous Audit Reports.
- (6) Other necessary papers required under the set rules for the conduct of the audit-work.

So, working papers are essential for the success of audit. After the audit report has been prepared and delivered to the client, the working papers are to be preserved for a period of five to ten years.

(4) AUDIT NOTE BOOK

The audit clerk maintains the audit notebook. He keeps therein a record of his observations during the course of any audit work as also the points to be discussed with his senior clerk or the auditor. It is a written record of the queries made by him and the replies thereto. It is part of permanent record of the audit office, which is used by the auditor while preparing his report.

Some of the important matters recorded in the Audit Note Book are as follows:

- Name of the business.
- Instructions from the management having relevance to the audit.
- List of book of account maintained by the enterprise.
- Accounting methods followed in the enterprise, and their defects.
- Any irregularities in the observance of laws and notifications applicable to the enterprise.
- List of missing vouchers and receipts.
- Matters requiring explanation or clarification.

It should be noted that an audit notebook is meant to record only important and strategic items. Matters, which are, or can be sorted out on the spot, or those of a trivial nature, need not be entered therein.

Advantages

- The auditor is enabled to record important points, which arise during the course of his audit.
- He can produce this book as a documentary evidence in a suit filed against him for negligence or misfeasance.
- A notebook makes the work of audit convenient as all the important details about audit can be recorded in this book and, as such, any change in the staff of the auditor does not disturb or dislocate the work of audit.
- Such a book can help in making an assessment of the knowledge, efficiency and work of audit clerks.
- It makes the procedures of subsequent audit easier.
- It provides a key to evaluate the efficiency of the audit staff.

(5) "AUDITOR IS A WATCH DOG AND NOT A BLOOD HOUND"

The above said remark was observed in the case of **Kingston Cotton Mills Company's case**. In this case the accounts of the company has been falsified by its manager who overvalued the stock in trade and as a result of this the profits were inflated and dividend was paid out of capital.

Describing the duties and liabilities of an auditor, Justice Lopes in the above case observed that an auditor is a watchdog in the sense that it is his duty to protect the interest of the person by whom he has been appointed. His duty is confined to careful and intelligent enquiry only. He should exercise reasonable care and skill before he certifies anything as true and fair. He should be sincere, honest and methodical. He works as a watchdog trying to safeguard the interests of his master and in doing so, if he finds that there are errors and frauds in the accounts, he brings them to the notice of his master.

The auditor's role is not of a detective. He should not start his work with the suspicion that the employees of the concern are dishonest. He is not a bloodhound, as he does not conduct the examination of books of accounts with them the main object of detecting frauds and punishing the dishonest and unscrupulous employees. The judgment in the above case reveals three important aspects with regard to the duties and responsibilities of an auditor:-

- (1) It is not part of the auditor's duty to take the stock.
- (2) He is not a detective. He is a watchdog and not a bloodhound.
- (3) It is his duty to use so much skill, care and caution to perform his work which a responsibly competent, careful and cautious auditor would use.

By this decision, the auditor of a company has been relieved of a great deal of responsibility. However, this judgment was criticized by many persons on the ground that if an auditor can be relieved of his responsibility, by accepting certified lists of the debtors, bills receivable, cash in hand etc.

But, as per the judgment, if the auditor performs his work with intelligence and due care, he cannot be held responsible for the things for which he relies on the trusted officials of the concern.

So, it is truly said that auditor's role is of a watchdog and not a bloodhound.

(6) AUDIT PROGRAMME

By an audit programme we mean a written plan containing exact details with regard to the conduct of particular audit. It is description of the work to be done which is prepared by an auditor for the guidance and control of assistants. An audit programme provides a guide in arranging and distribution of work and in checking against the possibility of the omissions.

According to Howard Stettler "The programme is an outline of all procedures to be followed in order to arrive at an opinion concerning a clients' financial statement".

An audit programme should be elastic. An audit programme should be chalked out in such a way that if there may be any need for revision that may be carried out without any difficulty. For this purpose auditor takes the following steps:

- Collects necessary information about the accounts to be audited
- Evaluates Internal Control System
- Designs audit working papers

Advantages

- Audit programme is prepared to locate exactly the responsibility of every clerk in the auditor's staff.
- The auditor can know about the progress of the work done by his staff.
- Since the programme takes into consideration all the details involved in the work to be followed during audit, no portion of the work is left from checking.

- It increases the efficiency of his staff as in that case; possibility of errors and negligence is minimized.
- Another advantage that follows is that in case of clerk goes on leave; the portion of the work where he has left can easily be located and assigned to another clerk.
- Before signing the report, it is easily possible for the auditor to have the final review of the work done by him. At this stage, it may be explored whether everything has been completed or not.
- With the help of audit programme, the work of audit can be completed in time quite methodically and efficiently.

Disadvantages

- Due to fixed and strict audit programme, the audit work becomes mechanical and monotonous.
- As the audit programme prescribes the rigid routine, the audit staff does not display initiative in exploring more efficient ways of completing work.
- Audit programme is suitable for large business concerns and not for small concerns.
- Any defect in audit programme may leave certain items from being checked.
- Lack of proper audit procedure for different business concerns as each of these may be following different accounting procedures or may have a separate problem of its own.

(7) BALANCE SHEET AUDIT

As is apparent from the name itself, in Balance Sheet audit, the auditor checks capital reserves, assets, liabilities, etc., given in the Balance Sheet. He checks only those documents, which are related to the items given in the Balance Sheet. Such an audit is not conducted to check Profit and Loss Account and similar other transactions. The work of the auditor is confined to the Balance Sheet alone. In India, no distinction is made between annual audit and Balance Sheet audit.

The Balance Sheet audit is quite satisfactory for small or medium-sized business. But for big concerns having mechanized book-keeping records, such an audit would be not only unsatisfactory but in many cases totally impracticable. There would have been a large volume of transactions involving exhaustive summaries made before the total eventually reaches the final account.

Q 10) DISTINGUISH BETWEEN

1) Internal Audit Vs. Internal Check

Meaning : Internal check is the organization of staff for checking the work of one by the other. Internal audit is continues audit of accounts by employees of the business concern.

Object : Internal check aims to prevent errors and frauds. Internal audit aims to detect errors and frauds. Internal audit aims to detect errors and frauds.

Nature : In the case of internal check, recording and checking of entries is simultaneously done. In the case of internal audit, only checking of already recorded entries is done.

Scope : The scope of internal check is limited. The scope of internal audit is comparatively broad.

Appointment : In the case of internal check, no new member is employed as duties are so assigned that involved cross checking. In the case of internal audit, process of auditing is carried by special staff appointed for this purpose.

Detection : In the case of Internal Check, any error or fraud is detected at the time of inter checking. In the case of internal audit, any error or fraud is only detected at the end of audit work.

2) STATUTORY AUDIT VS. INTERNAL AUDIT

- a) **Object**: The object of internal audit is to fulfill the needs of management. The object of statutory audit is to fulfill the needs of proprietors.

- b) **Period:** Internal audit is carried on continuously throughout the year. Statutory report is carried on periodically and usually once in the year.
- c) **To carry out :** Internal audit may be carried out by a firm of practicing accountants or by own staff. The statutory audit is entrusted to a Chartered Accountant or a firm of Chartered Accountants.
- d) **Remuneration:** In case of internal audit, the management fixes the remuneration of internal auditor. In case of statutory audit, the shareholders fix the remuneration of statutory auditor.
- e) **Termination:** In case of internal audit, the management can terminate the services of internal auditor very easily. In case of statutory audit, the shareholders can remove the statutory auditor.
- f) **Compulsion:** Internal audit is not made compulsory. Statutory audit has been made compulsory.
- g) **Appointments:** Internal auditor is appointed by the management while the statutory auditor is appointed by the shareholders except in certain cases when he is appointed by the directors of the company or the Government.
- h) **Qualifications:** Internal auditor need not possess the qualifications as are laid down under Section 226 of the Companies Act while a statutory auditor must have those qualifications.
- i) **Status:** Internal auditor is an employee of the company while the statutory auditor is an independent person.
- j) **Objective:** An internal auditor has the primary duty to find out whether any error or fraud has been committed while the statutory auditor has to report whether the balance sheet and the profit and loss account of a company have been drawn up in conformity with law and whether they show true and fair view of the state of affairs of the company. Detection of errors and frauds are incidental duties of a statutory auditor.
- k) Internal auditor has to check all the transactions while the statutory auditor may apply test checks.
- l) **Report:** Internal auditor has not to submit any report to the shareholders while a statutory auditor has to do so.
- m) **Removal:** Internal auditor can be removed by the management or the directors while a statutory auditor can be removed only by the shareholders and not by the management or the directors.

3) DISTINCTION BETWEEN INTERIM AUDIT AND CONTINUOUS AUDIT

- a) In the case of continuous audit, the work of audit is carried on for the whole financial year according to the convenience of the auditor, while in interim audit, the audit work is done only up to a certain date.
- b) In the case of continuous audit, verification of assets and liabilities is done at the close of the financial year, while in the case of interim audit; such a work is done at the time of audit.
- c) The preparation of trial balance is not necessary at intervals when continuous audit is done, but in the case of interim audit, the trial balance has to be prepared.
- d) The auditor reports at the close of the financial year, in the case of continuous audit, but in the case of interim audit, such a report is to be submitted by the auditor at the time of audit.
- e) The continuous audit is expensive while interim audit is less expensive.
- f) The continuous audit causes inconvenience to the staff of the client while interim audit does not do so.

4) VOUCHING AND VERIFICATION

Vouching may be defined as the examination of the evidences offered in substantiating of the entries in the books. It consists of comparing entries in the books of accounts with documentary evidence in support there to.

Verification is the proof of accuracy of extension, footing, posting existence and ownership of assets.

BASIS OF DIFFERENCE	VOUCHING	VERIFICATION
1. Nature	It examines the entries relating to the transactions recorded in the books of accounts with the help of documentary evidence.	Verification examines truth about assets and liabilities appearing in the Balance Sheet of the concern.
2. Basis	It is based on documentary evidences.	It is based on personal investigation as well as documentary evidences.
3. Time	It is done during the whole year.	It is done at the end of the year when the Balance sheet of the concern is prepared.
4. Valuation	It is not concerned with valuation.	Verification includes valuation in its Scope.
5. Utility	It certifies correction of records.	It certifies the existence of assets and liabilities at balance sheet date.
6. Personnel	It is done by the junior staff of the auditor like audit clerk.	It is done by the auditor himself or by his assistant.

(5) CONTINUOUS AUDIT AND PERIODICAL AUDIT

A Continuous Audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular intervals during the periods.

Periodical audit on the other hand is that audit which starts after the books are closed at the end of the accounting period and thereafter is carried on continuously until completed.

CONTINUOUS AUDIT	PERIODICAL AUDIT
1) The coverage of the period of determined conveniently by both the client and the auditor.	The coverage of the period is usually one complete financial year.
2) The staff of the auditor frequently visits and checks the accounts of the business.	The auditor's staff visits the business only once after the close of the year.
3) The business transactions are checked as and when they are recorded.	The accounting transactions are checked long after they have been recorded.
4) The annual reports and accounts can be published quickly.	The annual reports and accounts are difficult to be published quickly.
5) It is an effective means to detect and prevent errors and frauds.	It is not an effective means in these directions due to time constraints.
6) Sufficient time is available for thorough and detailed examination of records.	Thorough detailed examination of records is not possible due to lack of time.
7) It helps an assessment of the current financial conditions of the business at short period intervals.	It helps an assessment of the financial conditions of the business on an annual basis only.

Q 11) EXPLAIN IN DETAIL WHAT IS VERIFICATION OF ASSETS

Verification means 'Confirming the Truth'. In an audit, it means to find out whether a state of facts recorded in the books is true. Verification is to establish:

- Existence of the actual items of assets and liabilities
- Ownership and possession of assets

- Proper classification and valuation of both assets and liabilities.

Objects of Verification

We can sum up the objects of verification as follows:

- To compare ledger accounts with Balance Sheet to ensure arithmetical accuracy.
- To verify physical existence of the assets as on the date of Balance Sheet.
- To verify the assets are free from any charge or mortgage.
- Business concern is the real owner thereof and all the assets are under its proper custody.
- To verify that each asset and liability is properly valued and correctly stated in the Balance Sheet.
- Proper classification of each assets and liabilities in the Balance Sheet.
- Business concern has the actual or constructive possession of all the assets.
- To detect any fraud or irregularity in the books of accounts.

Difference in Verification and Vouching

Very often, vouching and verification are considered to be one and the same thing. It is not so. A clear line of demarcation can be drawn between the two. Vouching is to examine the correctness and authenticity of the transactions recorded in the books of prime entry while verification is to confirm the value of assets and liabilities as shown in the Balance Sheet. As such, in verification it is not merely the duty of the auditor to see that assets have been acquired but he has to certify that such assets:

- (a) Exist with the business.
- (b) Are the property of the client.
- (c) Are valued at proper figures on a particular date, viz., the date of the Balance Sheet.
- (d) By vouching, the entries relating to different transaction are checked as per the records in the books of accounts. By verification, assets and liabilities are checked as recorded in the Balance Sheet of the business concern.
- (e) Vouching is based on the documentary evidence of the business concern. Verification is based on generally accepted principles of accounting.
- (f) Vouching is done for all the business transaction done during the period of audit. Verification is done for all the business assets and liabilities at the end of the year.
- (g) Vouching is not at all concerned with the valuation but verification includes valuation of assets and liabilities.
- (h) Vouching helps to detect errors and frauds in the business concern. Verification helps to certify the true and fair view of the Balance Sheet of the business concern.
- (i) Vouching is normally done by juniors known as audit clerks. Verification is done by auditors.

Some Important Sections Related with Audit

- 224. Appointment and remuneration of auditor.
- 224A Auditor not to be appointed except with the approval of the company by special resolution in certain cases.
- 225 Provisions as to resolutions for appointing or removing auditors
- 226. Qualifications and disqualifications of auditors
- 227. Powers and duties of auditors
- 228. Audit of accounts of branch office of company
- 229. Signature of audit report, etc.
- 230. Reading and inspection of auditor's report
- 231. Right of auditor to attend general meeting
- 232. Penalty for non-compliance with sections 225 to 231
- 233. Penalty for non-compliance by auditor with sections 227 and 229
- 233A. Power of Central Government to direct special audit in certain cases
- 233B. Audit of cost accounts in certain cases

SECTION 226: - Qualification and Disqualification of Auditor

Section	Related Matter
226 (1)	• Chartered Accountant with in the meaning of the Chartered Accountants Act, 1949 • a firm whereof all the partners practicing in India are qualified for appointment, as aforesaid, may be appointed by its firm name to be the auditors of a company in which case any partner so practicing may act in the name of the firm
226 (2)	• Not being in force
226 (3)	Disqualification of auditor • a body corporate; • an officer or an employee of the company; • a person who is a partner, or who is in the employment of an officer or employee of the company; • a person who is indebted to the company for more than Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs. 1000; and • a person holding any security of that company.
226 (4)	• disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company
226 (5)	• When the auditor appointed but later on he fails the requirement of sub section 3-4 then he will be automatically vacated.

SEC. 314 – A **C.A** is not disqualified if his relative or his employee works as a director, secretary or any other person. But the permission of **CG** is must

Sec. 224: - Appointment of Auditor

Section	Related matter
224 A	Cases when the auditor appointed by <i>SPECIAL RESOLUTION</i> • A company in which 25% of the SUBSCRIBED CAPITAL ○ A public financial institution (NABARD, ICICI, AVIC, HUDKO) or a government or the CG or any SG, or ○ A financial or any other institution established by provincial or State Act in which a SG, holds not less than 51% SUBSCRIBED CAPITAL ○ A nationalized bank or an GENERAL INSURANCE COMPANY ○ Any combination of these. • IN case of pass ordinary resolution than the appointment of auditor done by CG u/s 224 (3) • 25% capital is considered as the Closing date of the register of members
224 (1)	Appointment by Shareholders

224 (1A)	Intimation of auditor to join the job or not in the form 23B
224 (1B)	Ceiling limit of the auditors Total 30 co. audits but not more than 20 public co. in which 10 co. does not have the share capital more than Rs. 25 Lakh.
224 (2)	No notice of the intended resolution to appoint some other person or persons in place of the retiring auditor was received by the company that could not be proceeded with due to death, incapacity or disqualification of the other person or persons.
224 (3)	Appointment by C.G - In that case if auditor not appointed in A.G.M - In that case when the co. passes the ordinary resolution whether he pass the special resolution u/s 224 A. - Penalty is 5,000 rs. In case of default.
224 (5)	Appointment of First auditor - It can be appointed by the <i>Board of directors</i> within one month of the date of registration. - If fails to appoint it can be appointed in GENERAL MEETING* - first auditor doesn't need to intimate.
224 (6)	Appointment in case of casual vacancy* - Other than resignation all the cause the appointment done by the <i>BOARD OF DIRECTORS</i> - In case of resignation the auditor appointed in GENERAL MEETING*.

AUDITING IMPORTANT QUESTIONS (NOV 2008 – PCC)**SAP'S OR AAS – 1,3,5,7,10,11,17,19,20****QUESTIONS:**

1. Limitations of Auditing.
2. Qualities of a Good Auditor.
3. Difference between Auditing, Accounting & Investigation.
4. Powers of Company Auditor
5. Circumstances of special Audit.
6. Audit of issued shares for consideration other than cash
7. Audit of Buy Back of shares.
8. Schedule VI requirements.
9. Changes in Accounting Policies.
10. Objects of providing Depreciation.
11. Need for Evaluation of Internal Control system.
12. Audit of club.
13. Audit of fees collection of college.
14. Vouching of following Transactions.
 - a) Sale of scrap material.
 - b) Cash sales.
 - c) Receipts from Debtors.
 - d) Recovery of Bad debts written off early year.
 - e) Board directors fees.
 - f) Advertisement expenditure.
 - g) Preliminary Expenditure.
 - h) Traveling Expenditure.
 - i) Salaries & wages.
 - j) Retirement, gratuity.
15. How will you verify the following:
 - a) Good will
 - b) Patents & copy rights
 - c) Lease hold properties.
 - d) Railway sidings.
 - e) Live Stocks.
 - f) Contingent Liabilities.
 - g) Bank Borrowings.
16. Considerations while checking the adequacy of provisions for doubtful debts.
17. Direct confirmation procedure.
18. Appointment of Auditor by Central Government.
19. Provisions of Companies act regarding maintenance of books of accounts and records.
20. Kinds of Audit opinion.
21. Independence of Comptroller & Audit General (C & AG)
22. Features of EDP Environment.
23. Problems of Auditors in the case of Audit of small Companies.
24. Provisions of Companies act regarding maintenance of books of accounts and records.
25. Distinguish between
 - a) Audit Principles & Audit Techniques.
 - b) Capital Reserves & Reserve Capital.
 - c) Internal Audit & Statutory Audit.

- d) Capital Reserves & Revenue Reserves
- e) Internal Check Vs. Internal Audit.
- f) Reserves Vs. Provisions

Short Answer Questions

- 26. Cut off procedure.
- 27. Surprise Check.
- 28. Remuneration of Auditor.
- 29. Disclaimer of Report.
- 30. Extra-Ordinary Items.
- 31. Accounting estimates.
- 32. Depreciation Vs Fluctuation.
- 33. Engagement letter.
- 34. Letter of Weakness.
- 35. Management Representation letters.

Question 1

State with reasons (in short) whether the following statements are True or False: (Answer any ten)
(10 X 2 = 20 Marks)

1.	A company running a departmental store and having total turnover of Rs. 100 crores during the financial year 2006-07, need not get its branch audited whose turnover is Rs. 1.90 crores during the same year. True: As per rules to section 228 (4) of the companies (Branch Audit exemption) Rules 1961, where the aggregate value of goods sold by a branch office does not exceeds Rs. 2 lakhs or 2% of the average of the total turnover of the company, whichever is higher, the branch shall be exempted from audit. Hence the branch in question is not required to be audited.
2.	AAS-24 deals with responsibility of the auditor of the service organisation. False : AAS-24 is related to responsibility of the auditor of the client using the services of the service organization.
3.	AAS-9 is applicable when an auditor seeks legal opinion from an advocate. True: AAS 9 on using the work of an expert applies when the auditor seeks opinion/reports of an expert on any audit matter. Therefore AAS 9 is applicable when an auditor seeks legal opinion from an advocate.
4.	Accounts not maintained as per the Double Entry System becomes incorrect in the eyes of an auditor of a company. True
5.	All the joint auditors are jointly and severally responsible for the work, which is not divided und carried on jointly by all the joint auditors. True : As per AAS-12 on "responsibility of joint auditors" all the joint auditors are jointly and severally responsible for the audit work which is not divided and carried on jointly by all the joint auditors.
6.	An adverse report is one where an auditor gives an opinion subject to certain reservation. False: An adverse report is given when the auditor concludes that based on his examination he does not agree with the affirmation made in the financial statements.
7.	An auditor can be appointed as first auditor of a newly formed company simply because his

	name has been stated in the Articles of Association. False : First auditor of a newly formed company is to be appointed by the BOD within one month from the date of incorporation. An auditor cannot be appointed as first auditor simply because his name has been stated in the articles of association.
8.	An auditor cannot be held responsible for misconduct in cases he places absolute reliance on certificates given by the management. False
9.	An auditor is considered to lack independence, if the partner of the audit firm owns the building in which the client's business is situated. False : According to the Guidance Note issued by the ICAI on "Independence of Auditors", "Independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest." In this case of Renting of building to the client does not affect the independence.
10.	An expert for the purpose of AAS-9 is a person, firm or association of persons possessing special skill, knowledge and experience in auditing. False : An expert for the purpose of AAS-9 is a person, firm or association of persons possessing skill, knowledge and experience in a particular field other than accounting and auditing.
11.	An unexplained decrease in the Gross profit ratio may result due to fictitious sales. False : A fictitious sale will increase the gross profit ratio instead of decreasing it. G.P. Ratio normally comes down if there are unrecorded sales or fictitious purchase or decrease in closing stock.
12.	Appointment of both the external and internal auditors is done by shareholders in general meeting. False
13.	As per AAS-2, one of the objectives of the audit is to detect fraud. False : As per AAS-2, objective of an audit is to express an opinion on financial statements to help the users of the financial statements to determine the true and fair view.
14.	As per AS-13, Investment should be classified into Current investments and Marketable investments. False : As per AS-13, Investments are classified into current and long term investment. Marketable investments are short term and classified as current.
15.	Audit procedure and Audit technique are not one and same thing. True : The two terms, procedure and technique are often used interchangeably. In fact, however, a distinction does exist. Procedure represents the broad frame of the manner of handling audit work and the technique stands for the methods employed for carrying out the procedure.
16.	Auditor's lien on his client's books and record is not unconditional. True: The auditor can exercise his lien on client's books and records subject to the following conditions: (a) Document retained must belong to the client who owes the money. (b) Such documents must have come into auditor's possession with the client's authority. (c) Some work must have been done and fees for work performed must be outstanding.
17.	Capital Reserve and Reserve Capital are same. False
18.	CARO '2004 is also applicable to the audit of branch of a company, except where the company is exempt from the applicability of the order. True : CARO' 2004 is also applicable to the audit of branch of a company since subsection 3(a) of the section 228 of the Companies Act clearly specifies that a branch auditor has the same duties as the company's auditor.
19.	CARO, 2004 does not applies to a Foreign company. False : CARO' 2004 applies to all companies including foreign companies except Banking,

	Insurance, Sec.25 Companies and Private Ltd. Companies subject to certain conditions.
20.	Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of the data produced by accounting system. False : Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Here auditor is concerned with assertions that the control exists and is operating effectively.
21.	Components of Audit Risk does not includes sampling risk. True : As per AAS-6, three components of audit risk are Inherent risk, Control risk and Detection risk.
22.	Cost Audit is compulsory in all companies who maintain cost records. False
23.	Cut-off procedures are generally applied to trading transactions. True: They cover the areas of purchases, sales, inventories to ensure that transaction of one year do not get recorded in the following year or preceding year to ensure 'matching' and true and fair view of the accounts.
24.	For the purpose of AAS-10 "Principal Auditor" means the partner of the firm signing the Audit report. False : For the purpose of AAS-10, principal auditor means the auditor with responsibility for reporting on the financial information of an entity, when that financial information includes the financial information of one or more components audited by another auditor.
25.	Government companies are also to be considered for the ceiling on number of audits. True: In calculating the audit units only audit of corporations which are not companies and foreign companies are not included. Thus Government companies will be considered for ceiling on number of audits.(Section 224(1B) of the Companies Act, 1956)
26.	If appointment of a person as an auditor is void-ab-initio, it should be treated as a casual vacancy. False: If appointment of a person as an auditor is void-ab-initio, it should not be treated as a casual vacancy, rather this would give rise to powers of the central government to fill the vacancy u/s 224 (3) of the Companies Act, 1956.
27.	If internal control is satisfactory, external evidence is more reliable than internal evidence. False: In the case of satisfactory internal control system, internal evidence is more reliable since the situation will reveal appropriate evidence.(AAS 5 "Audit Evidence")
28.	If the auditor appointed at the AGM refuses to accept the same, the Company can appoint another person by holding General Meeting. False : This is not a casual vacancy. Since the newly appointed auditor has refused to accept the appointment, no appointment can be said to have been made at the AGM. U/s 224(3) of the Companies Act, 1956, the power vests with the Central Govt. to make the appointment.
29.	If the auditor believes that the concern will not continue as going concern, he should issue disclaimer of opinion. False : As per AAS-16, if the auditor believes that going concern assumption is inappropriate and the entity will not be able to continue its operation in future, he should express an adverse opinion.
30.	If the auditor finds that the entries in the books of accounts are supported by vouchers, his job is done. False
31.	If there is any non-compliance of Co.'s Act, auditor should include the same in his report. True
32.	If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditors opinion will prevail while reporting. False: As per AAS-12 "Responsibility of Joint Auditors", where the joint auditors are in

	disagreement with regard to any matter to be covered by the audit report each one of them should express his own opinion through a separate report.
33.	Interest accrued but not due on "Secured loans" is required to be shown under appropriate sub-heads under the head "Secured loans". False : As per Part-I, Schedule VI to the Companies Act, 1956 interest accrued but not due on secured loans is required to be shown under "current liabilities".
34.	Internal auditor of the company cannot also be its cost auditor. True: As per notification issued by the DCA, cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. If the cost auditor is also the internal auditor, he would not be able to discharge his duties properly.
35.	No difference between Auditing & Accounting, since both deal with financial statements. False
36.	One of the techniques used for gathering evidence is substantial review. False: One of the techniques used for obtaining evidence is analytical review procedure which consists of studying significant ratios and trends. (AAS 5 "Audit Evidence")
37.	Procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner. False : Procedural error arises when there is error in implementation of the procedure. If transaction has been recorded in a fundamentally incorrect manner it will result in error of principle.
38.	Surplus on the re-issue of forfeited shares standing to the credit of share forfeited account can be distributed as dividend. True: The surplus on reissue of forfeited shares is credited to capital reserve account being a capital profit. Capital profit realized in cash, authorized by the articles and remains surplus after revaluation of all assets and liabilities can be distributed as dividend. (Lubok Vs The British Bank of South America)
39.	Test checks refers to the out of routine checks that are carried out in the normal course of audit. False : Test checks refers to an audit procedure wherein only a part is checked to form an opinion instead of checking all the transactions.
40.	The auditor is expected to approach the accounts of a new client with a pre-supposition that the accounting method employed has certain loopholes. False
41.	The auditor should ascertain contingent liability from entries in the books of prime entry. False
42.	The auditor will be guilty of negligence when it is found that he did not exercise reasonable skill and care. True
43.	The first auditor appointed by the board of directors can be removed by the board at its subsequent meeting. False: The first auditor appointed by the board of directors may be removed at general meeting of the shareholders and not meeting of the BOD.
44.	The functions of the auditor are to bring to the notice of the management, if there exist any loopholes/flaws in the system of accounting. True
45.	The term 'fund' and 'reserve' can be used interchangeably. False : The term 'fund' in relation to any reserve should be used only where such reserve is specifically represented by earmarked investments.
46.	There is a direct relationship between detection risk and combined level of inherent and control risk. False: There is inverse relationship between detection risk and combined level of inherent and

	control risk. When inherent and control risk are high, detection risk needs to be low to reduce overall audit risk.(AAS 6 “ Risk Assessments and Internal Control”)
47.	When inherent and control risks are low, an auditor can accept a lower detection risk. False : As per AAS-6 on risk assessment and internal control, when inherent and control risk are low, an auditor can accept a higher detection risk and still reduce risk to an acceptable lower level.
48.	Where the accounts of the company do not present a “true and fair” view, the auditor should express disclaimer of opinion. False: An adverse opinion is appropriate where the reservations or the objections are so substantial that he feels that the accounts do not give a true and fair view. In this situation the auditor should give an adverse or negative opinion only.

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