

# **AUDITING NOTES**

Subject: AUDITING AND CORPORATE GOVERNANCE (BCH-6.1)

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# CONTENT COVERED

- Definition of Auditing
- Elements of Auditing
- Advantages and Limitations of Auditing
- Objectives of Auditing
- Principles of Auditing
- Detection of Frauds and Errors
- Structure/ Elements of Audit Theory
- Major Classification of Audits
- Audit Planning
- Audit Program
- Audit Notebook
- Audit Working Papers

## Definition of Auditing

- **ICAI** – The independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.
- **Montgomery, a leading American Accountant** – “Auditing is a systematic examination of the books and records of a business or other organization, in order to ascertain or verify, and to report upon the facts regarding its financial operations and the results thereof”.
- **Comprehensive Definition** – It is an examination of the accounting books and the relative documentary evidence so that an auditor may be able to find out the accuracy of figures and may be able to make report on the balance sheet and other financial statements which have been prepared from there.

# Elements of auditing

- A systematic process
- Management assertions and audit objectives
- Obtaining evidence
- Ascertaining the degree of correspondence between established criteria
- Communicating results

# Advantages of Auditing

## A. Businessman's point of view:-

1. Detection of errors and frauds
2. Loan from banks
3. Proper valuation of investments
4. Proper valuation of assets
5. Government acceptance
6. Suggestions for improvement
7. Better Reputation

## B. Investor's point of view

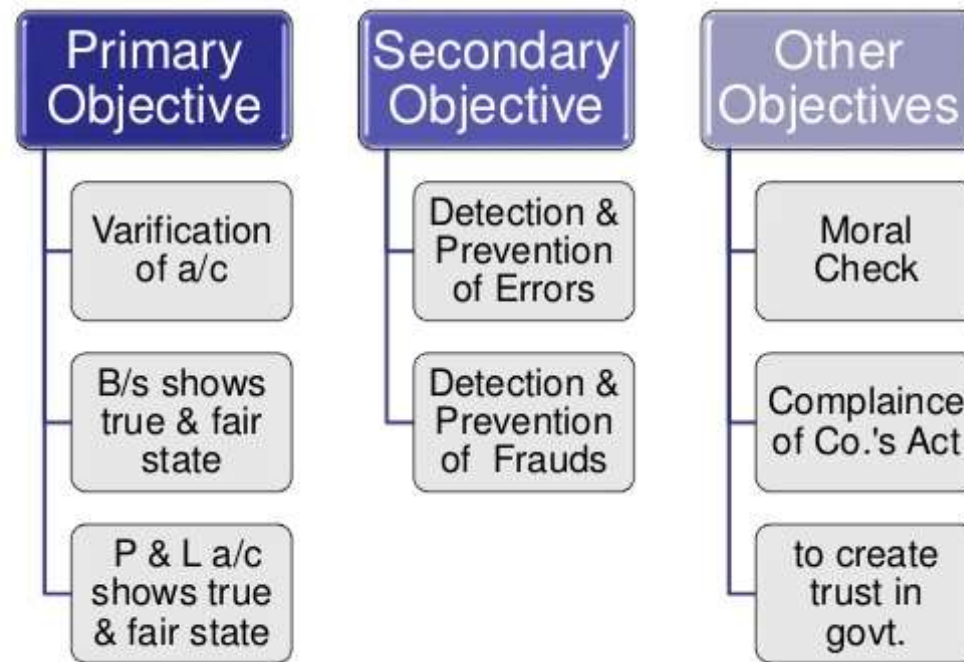
1. Protects interest
2. Moral check
3. Builds reputation
4. Good security



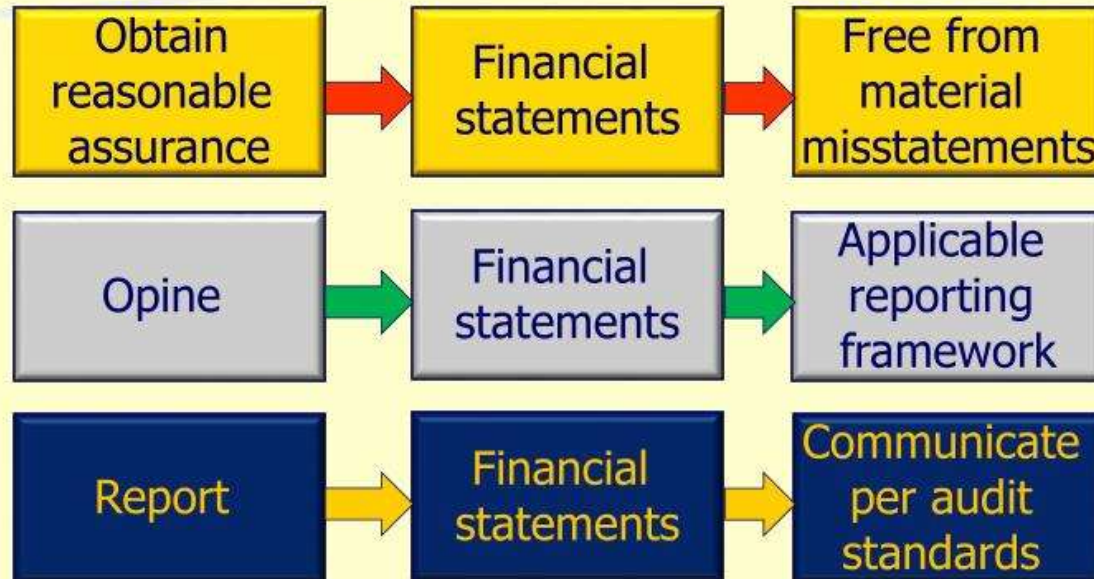
# Inherent Limitations of Auditing

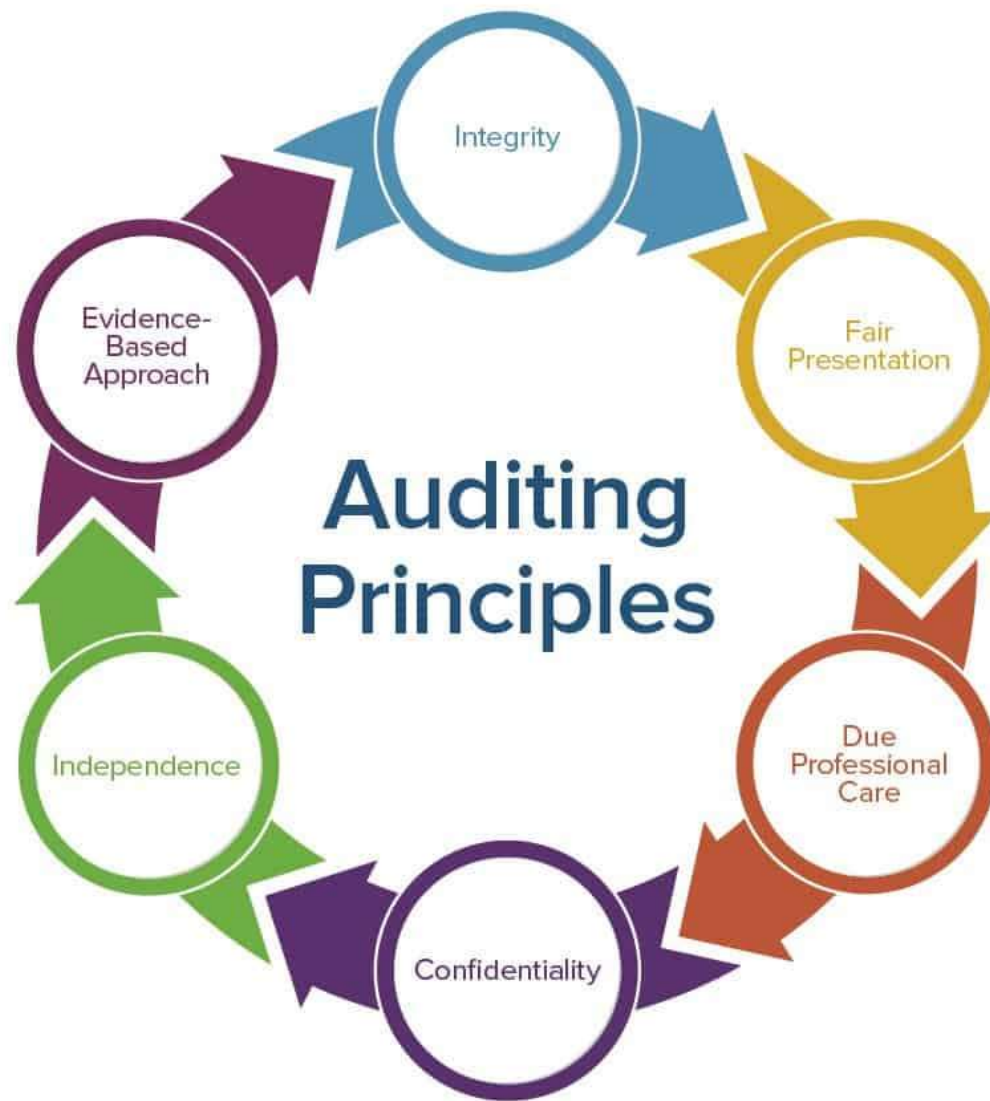
- 1) An auditor cannot check each and every transaction
- 2) Audit evidence is not conclusive in nature
- 3) An auditor cannot be expected to discover deeply laid frauds
- 4) Audit cannot assure future profitability and future prospects
- 5) Auditor has to rely upon experts
- 6) Auditor is supposed to be but may not be independent
- 7) Financial statements though audited have their inherent limitations

## Objects of Auditing



# Objectives of the Auditor

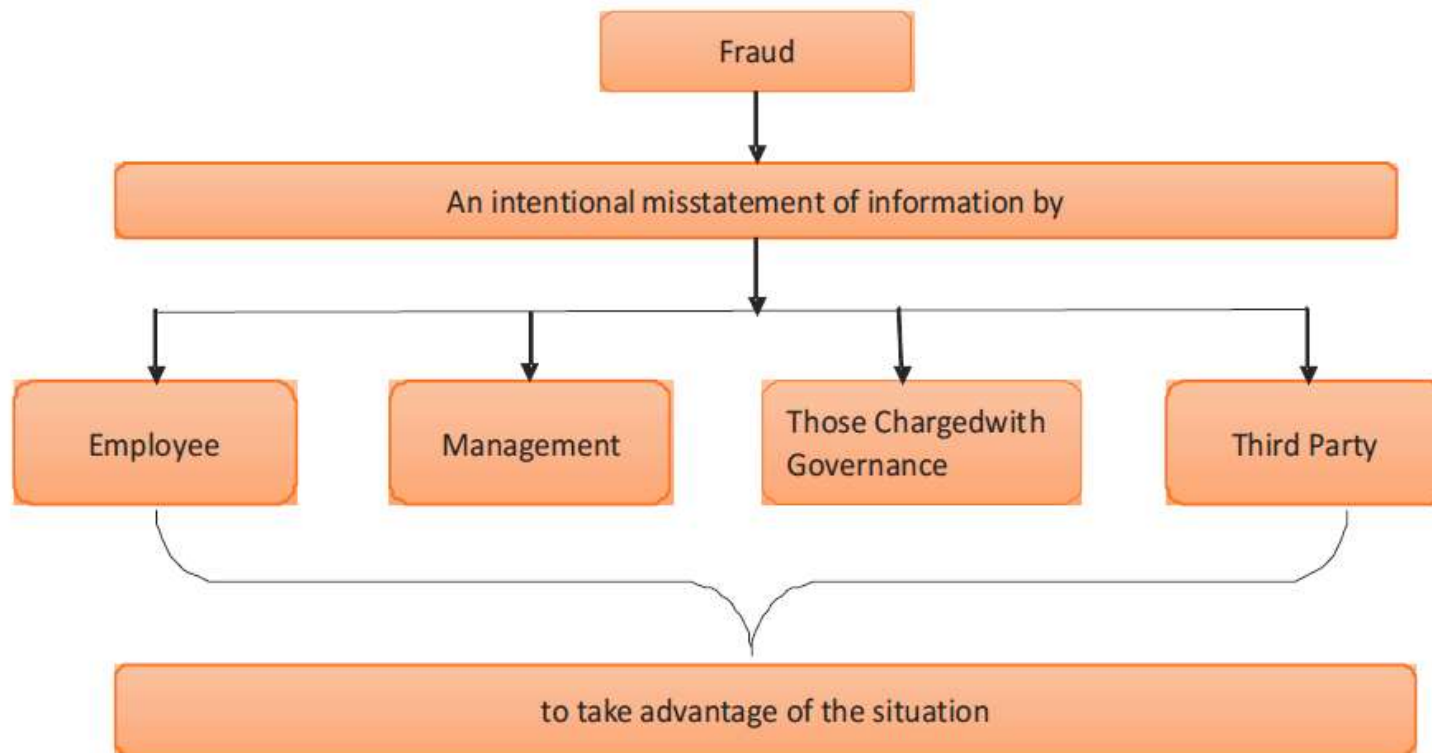






## Fraud – Introduction

- Primary responsibility for prevention and detection of fraud (and error) rests with management and those charged with governance
  - Good control environment
  - Risk assessment procedures
  - Implementation, operation, and monitoring of IC system
- Auditor's responsibility
  - Consider fraud when assessing risk of material misstatement
  - Respond to assessed, identified, or suspected risk
  - Able to express audit opinion at acceptable level of audit risk

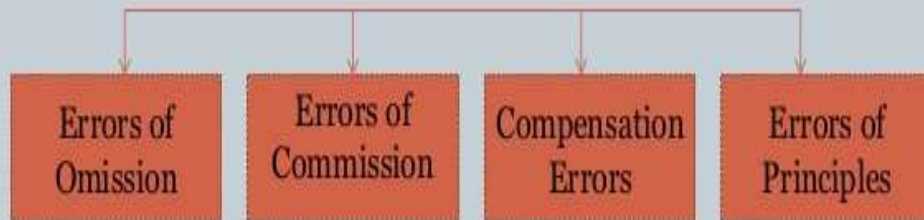


# ERRORS

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Errors are mistakes committed unintentionally because of ignorance, carelessness on the part of those responsible for the preparations of the accounts, while fraud involves some intention to gain out of manipulating records. .

Types of Errors:



## Types of Errors

- **Errors of Omission** – A transaction has not been recorded in the books of account either wholly or partially
- **Errors of Commission** – A transaction has been recorded but has been wrongly entered in the books of original entry or in ledger
- **Errors of Principle** – When entries are not recorded according to the fundamental principles of accountancy
- **Compensating Errors** – Also known as off setting error, is a type of error which is counter balanced by any other error or errors
- **Errors of Duplication** – An entry in a book of original entry has been made twice and has also been posted twice

# What if the auditor finds there is an error?

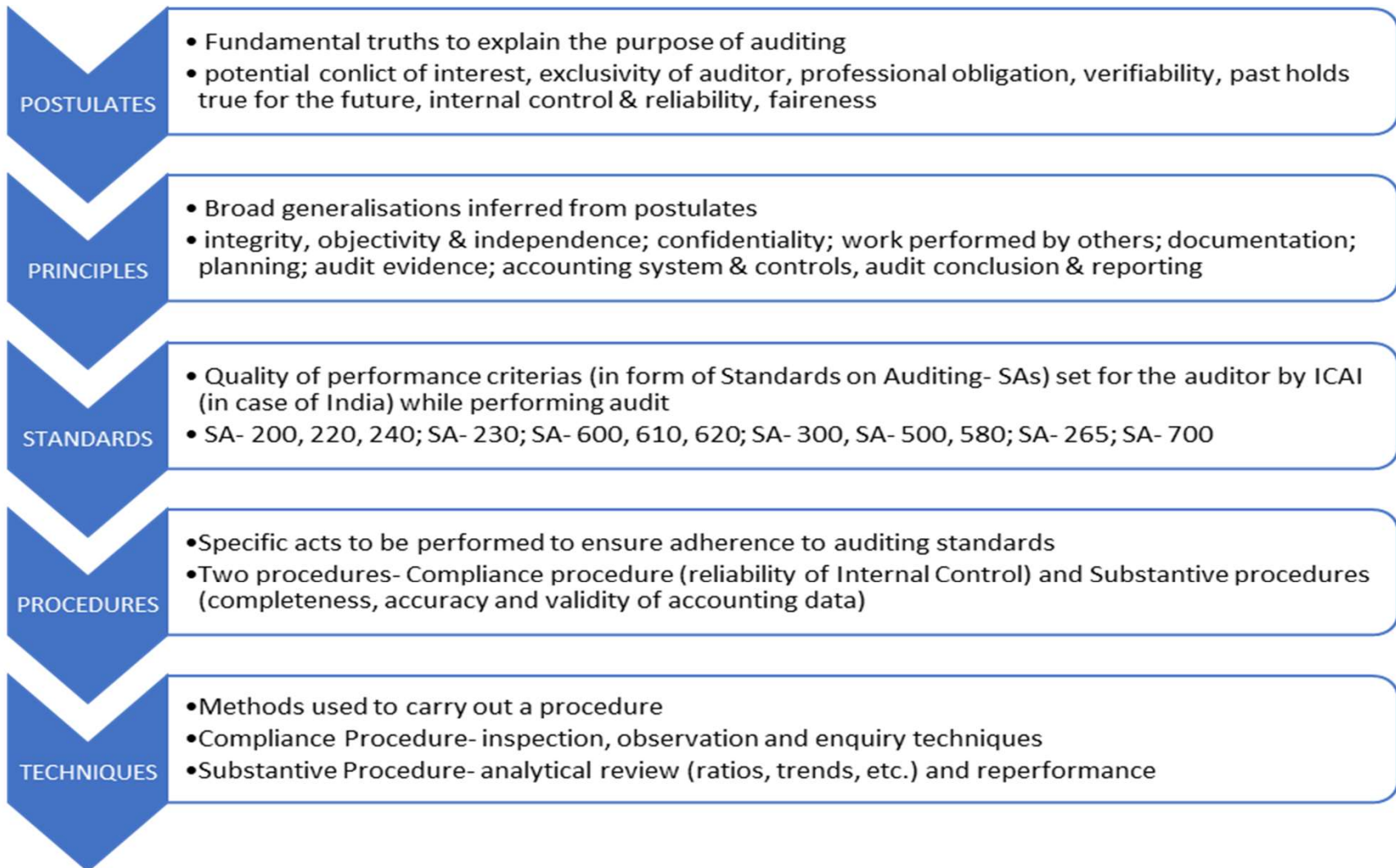
- If material error exists in the accounting records or financial statements, it must be the result of one or more of the following :
  - a) A large number of small error – should be detected by representative sampling.
  - b) Few large error – should be detected by selecting sampling.
  - c) A combination of (a) and (b) – both sample types will be needed



# Auditors responsibility for errors and frauds

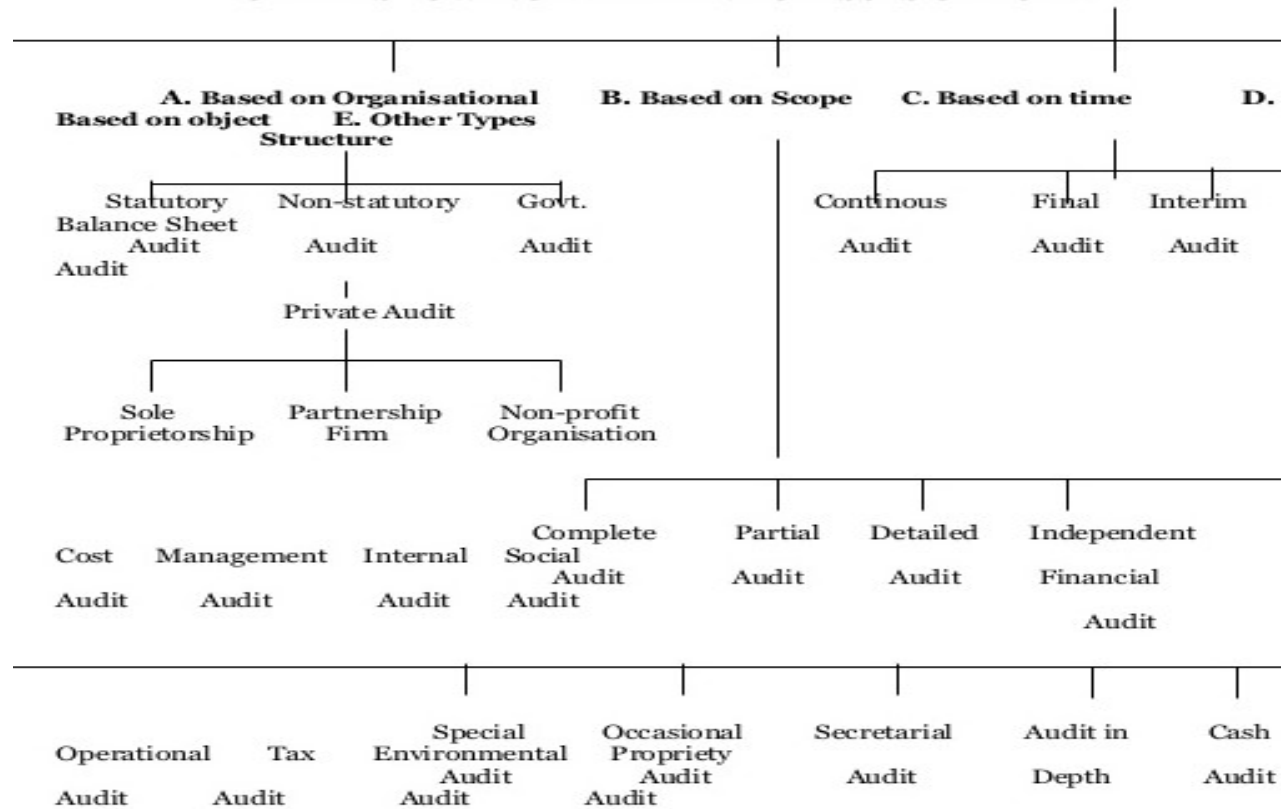
- Basic responsibility of Management – *for good accounting and internal control*
- Incidental Objective of Audit – *to ensure audit is free from major errors and frauds*
- Possibility of Non detection – *not failure in duty as long as reasonable care has been taken*
- When circumstances indicate error or fraud – *take additional steps to detect them and ensure proper closure or disclosure*
- CARO 2003 – *reporting requirements for fraud or error in the new format of CARO 2003.*

# STRUCTURE/ ELEMENTS OF AUDIT THEORY



## TYPES OF AUDIT

CHART SHOWING DIFFERENT CLASSES OF AUDIT





# Kinds of Audit

These audits have specific purpose and may or may not be statutory

1. **Cost Audit** – examine cost records, weaknesses in system, obligatory for some
2. **Tax Audit** – u/s 44AB of I.T. Act
3. **Management Audit** – comprehensive and constructive examination of company's organisational structure
4. **Social Audit** – special responsibility audit towards public, staff, government, etc
5. **Balance Sheet Audit** – commences from balance sheet and goes back to the books of accounts
6. **Systems based Audit** – evaluation of accounting system to ascertain reliability – proper system then minor checking, if not then detailed checking
7. **Energy Audit** – whether right amount of energy is used by the enterprise, done by technically qualified persons
8. **Secretarial Audit** – for Compliance with provisions of various Corporate Laws in terms of legality as well as in terms of timeliness. (replaced by compliance certificate by Company Secretary)



# Classification of Audits

## Interim, Final and Continuous audits :

- 1) Interim audit—during the year for a particular period of the year to avoid too much in the end
- 2) Final Audit – after the end of the financial year to audit complete accounts
- 3) Continuous Audit – Continuous and several visits ( similar to internal audit)



# Classification of Audits

## Statutory and Non Statutory Audits

- Statutory audits cover :
  - a) Companies
  - b) Banking companies
  - c) Electricity Supply companies
  - d) Co operative societies
  - e) Public and Charitable Trusts
  - f) Corporations
  - g) Societies

- **Statutory Audit**

- **Required under the statute i.e. under the Societies Act, Companies Act, etc.**
- **Done by an External Team of Auditors**
- **Scope of audit and report is determined by the Law**
- **In case of trust, there is no Statute, still, all the trusts normally provide for audits**
- **Societies have the provisions relating to Audit in their Charter**
- **Auditors' report is mandatory under the various Acts like FCRA, 2010 and Income-tax Act, 1961. [Form 10, Form 10BB]**
- **Section 8 companies are required for Statutory Audit under Companies Act, 2013**

No	Internal Audit	External Audit
1	Internal auditor is appointed by the management of the company.	External auditor is appointed by the shareholders of the company.
2	Legally internal audit is not compulsory.	External audit is compulsory by law.
3	Internal Audit work is a continuous throughout the year.	External Audit is done annually at the end of the fiscal year.
4	Internal auditor is employee of the company.	External auditor is an independent person.
5	Internal auditor has not to submit any report to the shareholders.	External auditor submits report to the shareholders.
6	Internal auditor checks all the transactions.	External auditor may apply test check.
7	Internal auditor gives suggestions to the management for the betterment of the business.	External auditor has no need to give suggestions unless he is asked.
8	Internal auditor primary duty is to find the frauds and errors	External auditor has to report about final accounts whether these are true or false

### Summary of Advantages and Disadvantages of Continuous Audit

Advantages	Disadvantages
1. Easy Detection of Errors and Frauds	1. Possibility of alteration
2. Quick presentation of accounts	2. Dislocation of client's work
3. Proper planning	3. No continuity in work
4. Moral Check on the Employees	4. Creation of unhealthy relationship
5. Detailed examination	5. Expensive
6. Preparation of interim accounts	
7. Valuable suggestion	

### Summary of Advantages and Disadvantages of Periodical Audit

Advantages	Disadvantages
1. No Inconvenience and Dislocation in work	1. Detailed checking not possible
2. Less expensive	2. Delayed Presentation of Audited Financial Statement
3. Quick finalisation of accounts	3. Difficulty in fixing responsibility
4. No chance of collusion	4. No moral check on clients staff
5. No chance of tampering books	5. Unsuitable
6. Time effectiveness	

### ADVANTAGES OF INTERNAL AUDIT:

1. Service to management.
2. Provides assurance of an effective system of internal control that is not excessive.
3. Ensures reliable basis for production of accounts and statements of trading.
4. Verifies the operation of established procedures and policies and sees that they are adequate, not wasteful.
5. Highlights departures from established procedures.
6. Draws attention to deficiencies in the system, control, practices etc.,
7. Finds inefficiencies.
8. Suggests remedies and improvements.

### Limitations of Internal Audit

- Internal auditor's report is **not accepted by the shareholders or tax authorities**. They require the external auditor's report.
- Since internal audit is done by the employees of the company chances are that it **may be biased** and therefore **company cannot depend on such reports**.
- As an internal audit is **not done by the professional auditor**, chances of internal auditor **not detecting the errors are high**.

## **Audit Plan**

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- A comprehensive list of the specific audit procedures that the audit team needs to perform to gather sufficient appropriate evidence on which to base their opinion on the financial statements
- When planning the engagement, the auditor needs to develop and document a plan that describes the procedures to be performed to assess the risk of material misstatement at the financial statement and assertion level
- The auditor must then carefully plan the nature, timing and extent of control tests and substantive tests that are designed to mitigate these risks to an acceptable level

# **AUDIT PLANNING**

- Preparations & Considerations by Auditor before commencement of Audit
- Audit Program
- Audit Note Book
- Audit working papers
- Audit Files
- Adoption of distinctive ticks
- Audit in depth
- Routine checking
- Test checking

## Preparation before the commencement of Audit

- Ascertain the scope of duties
- Procure engagement letter
- Knowledge about business
- Knowledge of the accounting system
- List of Principal officers
- Knowledge of the technical details
- Enquiry into special circumstances if any
- Instruction to the client

# Audit Programme

“An audit programme is an outline of all procedures to be followed in order to arrive at an opinion concerning client’s financial statements.”

Stettler

“An audit programme is a listing of evidence gathering procedures considered necessary to satisfy specific practical audit objectives.

Jack c. Robertson

- **Definition of audit programme.**

Set of procedures (evidence – gathering steps) that an auditor believes is necessary to perform to obtain reasonable assurance that the financial statements are not affected by material misstatements. An audit program is a set of policies and procedures that dictate how an evaluation of a business is done. This generally involves specific instructions as to what, and how much, evidence must be collected and evaluated, as well as who will collect and analyze the data and when this should be done. These types of programs are used to check up on things like a business' performance, finances, economy, and efficiency, and are generally tailored to a specific business or purpose.

**Purposes of audit programme**

- ✚ Guiding audit staff in audit work
  - ✚ Provide evidence of proper planning and recording of audit work to be done
  - ✚ Provide the basis for coordinating and supervising audit work and controlling the time spent
  - ✚ Audit programs are important because they standardize the data collection and evaluation process. By setting out a specific list of steps to be followed and data to be collected, the program ensures that auditors collect all the information they need in an efficient manner while under appropriate supervision. Keeping the process standardized also means that all the data collected can be used to make useful comparisons between businesses, departments, and previous years' inspections, since the same set of data is collected each time. Additionally, having a program like this in place makes sure that any problems are discovered promptly and reported to the correct person.
- **Main components of audit programme** will include the objectives, procedures and conclusion of each audit work performed.

### Summary of Advantages and Disadvantages of Audit Programme

Advantages	Disadvantages
1. Helps in estimation and division of work	1. Mechanical
2. Helps in fixation of responsibility	2. No quality in work
3. Helps in future planning	3. Loss of initiative
4. Serves as a guide	4. Rigidity
5. Valuable evidence	5. Shelter for inefficient staff
6. Uniformity	6. Unsuitable
7. Continuity	
8. Coordination	

# Contents of Audit Note Book

- A list of books of accounts maintained
- The name duties and responsibilities of principal officers
- The particulars of missing receipts and vouchers
- Mistakes and errors detected
- The points calling for clarifications and explanations
- The points deserving the attention of the auditor
- Various total and balances
- Extracts from the minutes and contracts
- The points to be part of the Auditor's report
- Date of commencement and completion of Audit

## **AUDIT WORKING PAPERS**

### **What are Working Papers?**

Working Papers are the material that auditors prepare or obtain and retain in connection with the performance of the audit. It may be in the form of data stored on paper, film, electronic media, or other media. They can also be used in court e.g. in case of negligent audit.

### **REASONS IN PREPARING WORKING PAPERS**

- ✚ Basis for planning the audit
- ✚ Record the evidence accumulated and the results of the audit tests
- ✚ Data for determining the proper type of audit report
- ✚ Basis for review by supervisors and partners
- ✚ Evidence audit works being performed in accordance with approved auditing standards

### **PURPOSE OF AUDIT WORKING PAPER**

Working papers are the evidence of work done by the auditor, he should prepare working papers in order to provide evidence that audit was properly performed according to ISA standards. Working papers support auditor, in-case he is being sued in court by the client, for negligence of audit work.

- Assist in the planning and performance of the audit.
- Assist in the supervision and review of audit work.
- Record the audit evidence resulting from the audit work performed to support the auditor's opinion.

#### **Purposes Served By Work Papers**

1. Audit working papers serve four major purposes:
  - A. They constitute a permanent record of the objectives and scope of the audit, as well as the work performed during the audit. Work papers organize and coordinate all phases of the audit.
  - B. They contain the back-up material in support of the audit findings

**Importance of Audit Working Papers:**

1. It provides guidance to the audit staff in regards to the way of checking the schedules.
2. The auditor is able to trace responsibility on the staff member who signs each schedule checked by him.
3. It is evidence in the court of law when a charge of negligence is brought against the auditor.
4. It presents the audit plan to be executed by the auditor to estimate the time required for checking the schedules.

The auditors should adopt reasonable procedures for protection and privacy of their working papers and should keep them for a period of time sufficient to meet the needs of their work and satisfy any important legal or professional requirements.

# *Audit Workpapers*

Audit working papers should document the following aspects of the audit process:

- Planning.
- The examination and evaluation of the adequacy and effectiveness of the system of internal controls.
- The auditing procedures performed, the information obtained, and the conclusions reached.
- Review.
- Reporting.
- Follow-up.

*End of Presentation*