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**ELEMENTS OF
AUDITING**

By: Yogita Singh, M.B.A. (Finance)

*Question Bank cum Chapterwise Reference Book
Including Many Solved Question Papers*



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**Sample Preview
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QUESTION PAPER

(June – 2019)

(Solved)

ELEMENTS OF AUDITING

Time: 2 Hours]

[Maximum Marks: 50

Note: Attempt any five questions. All questions carry equal marks.

Q. 1. Define auditing and state its advantages.

Ans. Ref.: See Chapter-1, Page No. 7, Q. No. 1 and Page No. 11, Q. No. 6.

Q. 2. State the difference between:

(a) Audit planning and Audit programme

Ans. Ref.: See Chapter-3, Page No. 28, 'Audit Planning', 'Purpose of Planning', Page No. 29, 'Audit Programme' and Page No. 30, 'Main Purpose of Audit Progress'.

(b) Internal Audit and Statutory Audit

Ans. Ref.: See Chapter-2, Page No. 16, 'Internal Audit and Statutory Audit'.

Q. 3. What is a Voucher? State the points to be kept in mind while examining Voucher.

Ans. Ref.: See Chapter-4, Page No. 47, Q. No. 3.

Q. 4. How would you verify and value the following:

(a) Book debts

Ans. Ref.: See Chapter-7, Page No. 73, 'Book Debts'.

(b) Investments

Ans. Ref.: See Chapter-7, Page No. 71, 'Verification and Valuation of Investment'.

Q. 5. State the qualifications and disqualifications of a company auditor. What is his status?

Ans. Ref.: See Chapter-8, Page No. 89, Q. No. 2 and Page No. 85, 'Status of the Audit'.

Q. 6. Define Vouching. How would you vouch the following:

(a) Packages and Empties

Ans. Ref.: See Chapter-5, Page No. 52, 'Packages and Empties'.

(b) Goods sent on consignment

Ans. Ref.: See Chapter-5, Page No. 51, 'Goods sent on Consignment'.

Q. 7. Comment on the following statements:

(a) The financial statements give a true and fair view of the company.

Ans. Ref.: See Chapter-11, Page No. 119, 'True and Fair Concept'.

(b) Management audit begins where the work of financial audit ends.

Ans. Management Audit is a process of examination and evaluation of the performance of managerial functions. It also covers the organisational structures of a company. It involves a critical review of policies, processes, procedures and operations which form part of the internal control system. It analyses the effectiveness in the utilisation of different resources. Management audit thus is an appraisal of both policies and actions. Financial auditing refers to an accounting process applied in business. The process involves using an individual body for evaluating the financial transactions and statements of a business. The ultimate purpose of financial audit is presenting an accurate amount of the business transactions of a company. Management audit, in effect, investigates into the soundness of management and its efficiency of operations. The

report of financial audit is helpful in analysing the position of the business of the company. Management audit is an assessment of the systems which are being used in an organisation. It identifies areas of weakness in internal control and suggests measures to improve performance. Thus, we can say that management audits begins, where the work of financial audit ends.

Q. 8. Write short notes on the following:

(a) Audit Note Book

Ans. Ref.: See Chapter-3, Page No. 36, Q. No. 7.

(b) Secret Reserves

Ans. A reserve which maintained to strengthen the financial position of the business without disclosing it in the book is known as secret reserve. Secret reserve is hidden reserve which is not disclosed by the balance sheet. Secret reserve is also known as internal reserve. It is created by showing the figure

of net profit less than actual. Its existence makes the financial position of the business better than what the balance sheet is disclosing. Generally, it is maintained by bank, Insurance and other financial institutions. The effect of secret reserve is to maintain the confidence of the customers and creditors by giving the impression of stability to a prosperous but fluctuating business, to check speculation in its shares and avoid disclosing information to competitors. There is, however, no doubt about the fact that where a secret reserve exists, the Balance Sheet of the business will not reveal the correct view of the financial affairs of the business.

(c) Divisible profits

Ans. Ref.: See Chapter-10, Page No. 111, Q. No. 1.

(d) Errors of principle

Ans. Ref.: See Chapter-1, Page No. 12, Q. No. 8 (b).

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Sample Preview of The Chapter

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ELEMENTS OF AUDITING

FUNDAMENTALS OF AUDITING

Basic Concepts



INTRODUCTION

The word **Auditing** has been derived from the Latin word "Audire" means to hear. With the coming of the Industrial Revolution and setting up of the large scale industries the verification and checking up of accounts became all the more important. Auditing in its modern concept is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the Balance Sheet and the net income received by the Profit and Loss Account.

CHAPTER AT A GLANCE

Origin of Auditing

The Industrial revolution gave birth to the Joint Stock form of organisation. Under this form of organisation the shareholders contributed the capital and have no control over the day-to-day working of the organisation. The shareholders wanted to know about the financial position of the organisation and therefore, arose the need of an independent person who would check the financial position of the company and report to the shareholders on the accuracy of the accounts and safety of their investment. The system of accounting and auditing could be dated back to Kautilyas '**Arthashastra**' which had the details regarding accounting and auditing of state finances.

It was the Indian Companies Act, 1913 who prescribed the qualifications of an auditor, the procedure for appointment and his powers and duties. A person cannot be qualified to be an auditor unless he is a Chartered Accountant within the meaning of Chartered Accountants Act, 1949.

Definition of Auditing

The word auditing has been defined from the Latin word 'audire' meaning 'to hear'. According to **Spicer and Pegler**, "An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial period, according to the best of the information and explanation given to him and as shown by the books, and if not, on what respect he is not satisfied."

According to **Montgomery**, "Auditing is a systematic examination of the books and records of a business or the organisation in order to ascertain or verify and to report upon the facts regarding the financial operation and the results thereof".

According to **R.G. Williams**, "Auditing may be defined as the examination of the books, accounts and vouchers of a business with a view to ascertain whether

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or not the Balance Sheet is properly drawn up as to show a true and correct view of the state of affairs of the business."

Thus audit is an independent and systematic examination of the books, accounts, records and financial statements and all supporting vouchers and

documents of a business or other organisation, for verifying whether the accounting records truly and properly reflect all the transactions.

Difference between Accountancy and Auditing

Accountancy and Auditing are two different concepts. Following are the differences between the two:

Basis	Accountancy	Auditing
1. Nature of work	Accountancy includes the preparation of Trading, Profit and Loss Account and the Balance Sheet.	Auditing examines and verify the financial records and statements of affairs to ascertain whether the financial records give a fair view or not.
2. Starting and ending point	Where accountancy ends, auditing starts.	When the work of auditing begins, the work of accountancy ends.
3. Qualification	To be an accountant a person must have the basic knowledge of accountancy.	To be an auditor a person must be a Chartered Accountant.
4. Job performance	An accountant is not allowed to conduct an audit unless he has passed the necessary examination of being an auditor.	An auditor can perform the work of an accountant since he is supposed to have complete knowledge of accounts.

Difference between Auditing and Investigation

Investigation implies an enquiry into the accounts and records of a business concern. In other words investigation is an examination of accounts and records of a business concern with some special purpose in view.

Basis	Investigation	Auditing
1. Scope	Investigation is determined by the object intended to be achieved by the party on whose behalf investigation is undertaken.	An audit extends to all factual assertions in the financial statements with a view of a ascertaining their truth.
2. Compulsory	The investigation of books of accounts and records is not legally compulsory.	Audit is compulsory in case of Joint Stock Companies.
3. Time Coverage	The period covered by an investigation is determined by the objectives. It may be for a week, month or extend to several years.	An audit examination generally covers the accounting year of the client.
4. Disclosure Requirements	There are no legal requirements as to disclosure of information in an investigation.	The auditor is legally required to ensure complete disclosure of the information as prescribed.

Basis	Investigation	Auditing
5. Qualification	It is not necessary that an investigator must be a Chartered Accountant.	Auditing can be conducted by a practising Chartered Accountant.
6. Utility	The results of investigation are beneficial only to the client.	The results of auditing are widely used.

Objectives of Audit

The objects of audit can be classified as Main Objects and Subsidiary Objects.

Main Objects: The main object of audit is to verify the accounts and to report whether the Balance Sheet and the Profit and Loss Accounts have been drawn properly according to the Companies Act and whether they exhibit a true and fair view of the state of affairs of the business. The verification of accounts is done to see if they are correct, complete and in conformity with the law.

Subsidiary Objects: The subsidiary objects of the auditor are:

- (a) Detection and Prevention of Errors
- (b) Detection and Prevention of Frauds.

I. Detection and Prevention of Errors: Errors are of various types:

(a) **Clerical Errors:** Such an error arises due to the mistake of the clerk. Clerical errors are of three types:

(i) **Error of Commission:** Error of Commission arise through negligence in the matter of recording some business transactions in the books of accounts. If an item is incorrectly recorded in the journal and posted in the ledger, it is an error of commission. Examples are incorrect recording, incorrect posting or posting an item to a wrong account, errors in totalling and balancing and errors in carrying forward totals to trial balance.

(ii) **Error of Omission:** If a transaction has been omitted from being entered in the book of accounts, wholly or partially it is an example of error of omission.

- Where items remain partially recorded.
- If an item has been recorded in the journal but not posted in ledger.
- The error which arise due to non-recording of certain items will not affect the trial balance and as such omission can be detected by careful scrutiny of the books of accounts.

(iii) **Compensating Error:** It arises when an error is counter balanced or compensated by any other error so that the adverse effect of one on debit or credit side is neutralised by that of another on debit or credit side. Compensating errors will not affect the trial balance and as such will not be detected easily. Hence, their detection requires complete and exhaustive preparation on the part of the auditor.

(b) **Errors of Principle:** They arise out of disregard for the principles of accountancy like incorrect allocation of expenditure between capital and revenue, posting of revenue items to the wrong class of revenue account (Wages posted to general expense), posting of an item of revenue or expenditure to the personal account, valuation of assets against fundamental principles of accountancy.

Detection and Prevention of Frauds: Fraud is a false representation or entry, which is made always intentionally with some fraudulent objectives.

(i) **Mis-appropriation of Cash:** Usually, cash is mis-appropriated by theft of cash receipts and petty cash, theft of cheques and other negotiable instruments, payment made to fictitious creditors or workmen. Mis-appropriation or defalcation of cash is a very easy affair. Anybody with a little skill on his part can mis-appropriate money, especially in a big business house where the contacts between the proprietor and the persons handling the cash are not so close.

(ii) **Mis-appropriation of Goods:** Goods can be mis-appropriated by:

- (i) The actual theft of stock and/or
- (ii) The issuing of fictitious credit notes to customers where there is collusion of the employee with the customer.

The chances of mis-appropriation of goods is more where goods are less bulky, highly priced and easy to carry without detection. Only detailed checking by the auditor can bring fraud to light. He should check up the stock records, purchases and sales very carefully.

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(iii) Manipulation of Accounts: The fraud is committed by persons holding high position in the organisation. This can be done when a person:

- (i) Makes a false entry;
- (ii) Alters a true entry;
- (iii) Omits to enter a true transaction.

Window Dressing: It is one of the ways of falsification and manipulation of accounts. Window dressing implies showing a more prosperous position of financial accounts than what actually it is. It is more in nature of mis-representation. The objectives behind window dressing are:

- Obtain further credit.
- To attract the shareholders.
- To win the confidence of the shareholders.
- To raise the price of shares in the market by paying higher dividends so that shares held may be sold.

Secret Reserves: When the accounts are prepared in such a way that they disclose the worse picture than actually what they are it is known as secret reserves. The main objectives are:

- Avoid the tax liability
- Conceal true position from the competitors
- Reduce the prices of shares in the market.

Advantages of Auditing

1. Audit is helpful in detecting errors and frauds committed in the books of accounts and efforts are made that these errors are not repeated.
2. Audit plays an important role in the field of business as it requires the books of accounts to be audited from time-to-time. Examination of books of account makes the employees disciplined and creates interest in them to perform the allotted work.
3. Audit accounts are readily accepted by the revenue authorities like Income Tax, Sales Tax etc.
4. Audit proves that the Profit and Loss Account and Balance Sheet show true and fair view, which is helpful in the determination of the economic policy of the organisation.

5. Financial Institutions consider the Audited accounts for loan processing.
6. The audited books of accounts helps in settling the claims from various insurance companies or from persons responsible for incurring losses.
7. Before the declaration of dividend and bonus, a certificate for the truthfulness of profit and loss has to be taken so that no doubt is aroused in the minds of shareholders and the workers because they have confidence in the audited books of accounts.
8. Audited accounts help in the determination of purchase price for the business.
9. Audit plays an important role to removing corruption. If audit is not done, the employees of the organisation can mis-appropriate goods and cash being fear free. But by adopting the work of audit, corruption can be controlled to some extent.

Different Classes of Audit

1. Audit under Statutes: This is also called as Statutory Audit. In case of a company where audit is made compulsory by law is called Statutory Audit. It is so because these companies are formed under statute. Statutory Audit has been prescribed in the following cases:

- Banking Companies
- Insurance Companies
- Co-operative Societies
- Public and Charitable Trust
- Local Authorities and Government Undertakings.

Since audit is made compulsory in the above Companies even the shareholders of these enterprises cannot make it optional by their unanimous vote and can't restrict the scope of such an audit.

2. Audit of accounts of private firms: A partnership firm is based on mutual trust and confidence of the partners. Audited books of accounts help them in reposing and maintaining this trust. The auditor should pay attention to the following documents while conducting the audit of the partnership firm: Partnership Deed, Nature of Business, borrowing powers of partners,