

CONTEMPORARY AUDITING

For Students

FOURTH EDITION

KAMAL GUPTA



CONTEMPORARY AUDITING

FOR STUDENTS

Fourth Edition

KAMAL GUPTA

*Technical Director
The Institute of Chartered Accountants of India
New Delhi*



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Foreword

I have great pleasure in writing this Foreword to Mr Kamal Gupta's book, *Contemporary Auditing*. Mr Gupta is a senior member of the teaching staff of the Institute of Chartered Accountants of India and his book is based on his practical experience in the profession as well as his teaching experience in the field of auditing and other allied subjects.

I am particularly impressed by the fact that the book does not deal with the subject of auditing merely by way of an enumeration of the various techniques and procedures. Instead, the author has devoted considerable thought to the underlying philosophy of auditing and its conceptual basis. At the same time, his dissertation on the theory of auditing is duly supplemented by a discussion of its practical applications.

The subject of auditing has undergone radical changes in present times. It is no longer assumed that auditors have a responsibility only to those who specifically engage their services. Social responsibility is now more than a mere dogma. It has been translated into practical effect not only by various pronouncements of the Government authorities but also by the changing attitudes within the profession itself. These developments find an appropriate place in this book.

Mr Gupta has also given attention to certain recent developments in the auditing profession. For example, he has dealt with the subject of statistical sampling, flow charting and other similar applications and techniques of recent origin. This will greatly enhance the value of the book as a practical guide to students and practitioners.

Another recent development which has been noticed by Mr Gupta in his book is the increasing emphasis being placed on the acceptance of international standards, both in accounting as well as in auditing. Company accounts are being increasingly mechanised. With the enormous developments taking place in the electronics industry in India the time is not far off when the use of computers and other mechanised equipment will be fairly widespread. Consequently, I am glad that Mr Gupta has dealt with mechanised accounting and the problems of audit of mechanised accounts in his book.

Because of the somewhat unusual and wide-ranging treatment given by Mr Gupta to the subject, I am confident that the book will appeal to a large and wide section of readership. Members and students of the Institute will find it useful because of its practical orientation, while those who are interested in establishing the conceptual basis of the profession and in seeking its motivations and objectives will find in the book useful material for further study and research.

I have every confidence that the book will find a useful place in various libraries and in the offices of practitioners not only in this country but also abroad.

Preface to the Fourth Edition

A number of significant developments affecting the work of auditors and accountants have taken place in the recent years. Firstly, the Companies (Amendment) Act, 1988 has brought about a number of changes of far-reaching importance in the principal Act. Further, in 1988, the Central Government issued a new Manufacturing and Other Companies (Auditor's Report) Order, superseding the earlier Order issued in 1975. Moreover, the formats of long-form audit reports in the case of banks and the tax audit reports under section 44AB of the Income-tax Act, 1961 have been amended. A number of new or revised pronouncements have been issued by the Institute of Chartered Accountants of India and the international bodies of professional accountants, viz. the International Federation of Accountants and the International Accounting Standards Committee. The ethical standards of professional accountants have also undergone a change; besides there have been new judicial decisions on matters of professional liabilities and misconduct. Lastly, significant changes in audit techniques have taken place in response to the increasing size of auditees and the growing use of computers in business.

This edition attempts to take cognisance of all the aforesaid developments. To do so, most of the chapters have been substantially revised and, in certain cases, almost rewritten. The main text of the book has been updated as of June 30, 1990. However, the rapid pace with which changes are taking place in this field has necessitated the inclusion of a separate appendix to cover developments between July 1, 1990 and December 31, 1990.

This fourth edition is presented in two separate modules. The present one caters primarily to the needs of students of chartered accountancy, cost accountancy, commerce and other allied disciplines. A feature of this edition that the students will find particularly useful is the inclusion of review exercises at the end of each chapter, which will not only enable them to recapitulate their understanding of each chapter but also help them in applying it to practical situations. The second version, which is expected to be released shortly, contains additional reference and analytical material to cater to the needs of professional accountants and auditors.

I would like to express my gratitude to the Institute of Chartered Accountants of India, the International Accounting Standards Committee, the International Auditing Practices Committee, and the American Institute of Certified Public Accountants for granting me permission to reproduce their statements and appropriate extracts from their other publications. I am also deeply indebted to my esteemed friend and colleague, Mr Ashok Arora, who, with his deep knowledge of the subject and remarkable ability for logical thought, made countless suggestions to improve the book. I am also grateful to my professional colleagues Mr Ashok Nanda, Mr M.M. Khanna, Mr Anil Chadha, Mr Ashok Mahindra and Mr P.R. Khanna for their kind advice and guidance. To my parents, my sister and my wife, I owe much for their innumerable acts of advice and help.

I would also like to clarify that the views expressed in this book are my personal views and should not be construed as the views of my employers, the Institute of Chartered Accountants of India.

During the last fifteen years or so since this book has been in print, a large number of my colleagues, students and friends have sent me their suggestions for improving its contents. While expressing my gratitude to them, I hope that I continue enjoying the privilege of their guidance in future also.

New Delhi
February 12, 1991

KAMAL GUPTA

Preface to the First Edition

This book seeks to emphasise that auditing is not only a practical subject but that it also has a basic underlying theory. It is, therefore, asserted that auditing, as a subject, should not be confined merely to procedural and mechanical instructions designed to check the various categories of transactions. Actually, it may not be wrong to state that too much emphasis on procedural aspects in the popular auditing texts has hampered the growth of auditing — both as a discipline and as a profession. There is no doubt that an explanation of 'how to do it' is important. But the questions which should logically be taken up first are 'what is to be done' and 'why is it to be done'. An auditor must understand the type and nature of propositions which he is trying to prove. He may then select the particular techniques which enable him best to collect evidence in support of the propositions. On the basis of the evidence so collected, the auditor may make his report keeping in view his responsibilities and the broader question of professional and social ethics.

Another objective of this book is to discuss the latest developments in the field of auditing. The last decade has witnessed significant changes in the scope and nature of auditing. New standards of accounting are being developed. The techniques of recording transactions have undergone a complete change. The social obligations of the profession have mounted. An attempt has been made to review these changes and to trace their impact on contemporary auditing.

The book is divided into sixteen chapters. After an introduction to the conceptual framework of auditing with special reference to the concept of evidence, the auditing practices that are accepted to be standard in India have been discussed in detail. The next chapter on internal controls, primarily shows how internal control questionnaires and flow charts can be prepared. In the chapter on selective verification, which follows, an attempt has been made to present the various statistical sampling plans in such a manner that an accountant can use them in practical situations, even if he possesses only a nodding acquaintance with mathematical and statistical formulations. The chapter on overall assessment, though brief, emphasises the need for formulating new techniques and standards of input-output analysis. Development of techniques for the audit of mechanised and EDP systems has assumed significance in view of the growing popularity of punched card installations and computers in India. The chapter on this subject may therefore be of interest, especially in view of the development of new techniques like test packs, controlled processing and computer audit programmes.

The next few chapters discuss the special features of audit of companies, banks, insurers and cooperative societies. A separate chapter has been devoted to the audit of public sector undertakings. Similarly, cost and managements audit, auditors' reports, divisible profits and investigations are considered in separate chapters. The broader issues of professional liabilities and ethics have

also been discussed at length. Finally, the emerging demands on the auditor have been briefly touched upon.

It is my hope that the book will be useful both to the professional accountants and to the students of chartered accountancy, cost accountancy and commerce.

I am grateful to the publishers, Tata McGraw-Hill, who managed this publication with efficiency and despatch. I thank the AICPA and IASC for granting me permission to use certain extracts from their publications.

I am thankful to many friends and colleagues who have gone through the earlier drafts of the various chapters in this book. In particular, my friend and colleague, Mr A K Majumdar has very kindly offered a number of comments and suggestions after going through most of the chapters. To my teacher, Prof. T S Grewal, I shall always remain beholden for advice and searching comments. I am also grateful to Mr P.M. Narielvala for writing the Foreword. I also thank Mr Nandan Singh who typed out the two drafts of the book with sincerity and accuracy. To my parents and to my wife, I owe a deep sense of gratitude for innumerable acts of advice, help and encouragement while the manuscript was under preparation. Indeed, full responsibility for the shortcomings of the book is mine. Also the views expressed herein are my own and should not be construed in any manner as the views of my employers, the Institute of Chartered Accountants of India.

With humility, I seek suggestions to improve the contents of this book.

New Delhi
August 9, 1976

KAMAL GUPTA

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Auditing Today

Auditing is a specialised function having complex legal, economic and ethical implications. The auditors examine and report on economic information relating to organisations in which millions of people have a stake either individually or through the state. They have, therefore, come to enjoy a distinctive professional status in the present-day society. This chapter briefly reviews the current status of auditing and the profession of auditors. The interrelated issues of the nature, objectives and emerging concepts of auditing are also discussed.

EVOLUTION OF AUDITING

To get an insight into the current status of auditing, an understanding of its evolution is essential. Such an understanding would also provide a basis for projecting the future of auditing. Though it is difficult to attempt an exhaustive survey of the history of auditing, some of the milestones in the development of auditing are identified below.

Checks in Ancient Systems

Auditing in its simple form originated almost simultaneously with the development of organised systems of accounting. As it became necessary to entrust one man with the property of another, the need for a check on the fidelity of the former arose. Mesopotamian relics of commercial transactions pertaining to the period 3600-3200 B.C. reveal tiny marks, dots, ticks and circles at the side of the figures, indicating that those figures had been checked.¹ The ancient Egyptians got their fiscal receipts recorded separately by two officials while another official conducted their audit. Later, the Greeks appointed checking clerks to scrutinise the accounts of public officials at the expiry of their term of office. The Romans, who designed an effective system of financial administration, distinguished between the person authorising expenditure and the person responsible for actual receipts and payments. They also instituted an elaborate system of checks and counterchecks within the financial administration.²

Pre-Vedic and Vedic literature contain numerous references which indicate that accountancy existed in a somewhat developed form in ancient India. For example, in Valmiki's *Ramayana*, Rama asked Bharata when the latter met him in the forest: "Is your income more than your expenditure and your expenditure less than your income?"³ In *Mahabharata*, King Yudhishtira ordered his brother Nakula to look after the army's accounts.⁴ Discussions in the Vedas on matters like the

¹ Kenneth S. Most, "Accounting by the Ancients", *The Accountant*, May 1959, p. 563.

² For details, see T. C. Richard Brown and E. C. Jack (eds), *A History of Accounting and Accountants*, Edinburgh, 1905, Ch. IV, p. 74.

³ *Valmiki Ramayana*, Ayodhya Kanda, Sarga 100.

⁴ *Mahabharata*, Shanti Parva, Sarga 40.