4th semester (Hons.)
Auditing
Unit :1 Introduction

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Auditing Introduction :-

The audit is an intelligent and critical examination of the books of accounts of the business. Auditing is done by the independent person or body of persons qualified for the job with the help of statements, papers, information and comments received from the authorities so that the examiner can confirm the authenticity of financial accounts prepared for a fixed term and report that:
The balance sheet exhibits an accurate and fair view of the state of affairs of concern;
The profit and loss accounts reveal the right and balanced view of the profit and loss for the financial period;
The accounts have been prepared in conformity with the law.
Thus, it will be seen that the duty of an auditor is much more than a mere comparison of the balance sheet and accounts with the books.
But, apart from doing this, he has to satisfy himself according to his information and the explanations given to him.

Meaning of Auditing :-

The term audit is derived from a Latin word "audire" which means to hear authenticity of accounts is assured with the help of the independent review.
Audit is performed to ascertain the validity and reliability of information. Examination of books and accounts with supporting vouchers and documents to detect and prevent error, fraud is the primary function of auditing.
Auditor has to check the effectiveness of internal control systems for determining the extent of checking out the audit.
Initially its meaning and use were confined merely to cash audit, and the auditor has to ascertain whether the persons are responsible for the maintenance of accounts had adequately accounted for all the cash receipts and the payment on behalf of this principle.
But the word audit has an extensive usage, and it now means a thorough scrutiny of the books of accounts and its ultimate aim is to verify the financial position disclosed by the balance sheet and profit and loss accounts of a company.
In short, an audit implies an investigation and a report. The process of checking and vouching continues until the study is completed and the auditor enables himself to report under the terms of his appointment.

Definition of Auditing :-

“An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which the purport to relate.” – Lawrence R. Dickey

“Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement.” – Taylor and Perry

Objectives of Auditing :-

Accounts and statements verification

Evaluating the fairness & accuracy of books of accounts is the primary objective of Auditing. It checks each & every financial transaction thoroughly. It detects and prevents any frauds in the books of accounts. The auditor is provided with free hands to audit the books of accounts & is independent of business.

Checking Accounting Policies

Every business or organisation needs to follow some accounting policies. Books of accounts are prepared according to these accounting policies. If a business has an effective accounting system, its efficiency can be increased. It is the duty of the auditor to check the accounting policies of business & express his independent opinion.

Error and Fraud detection

Auditing helps in easy finding of errors & frauds from the books of accounts. It is the duty of management to avoid & check errors & frauds. However, sometimes it becomes difficult for management to find out the errors.
It is through auditing that helps managers to find out errors & frauds. After this managers take corrective steps against these errors or frauds.

Improves Quality of Business processes

Auditing helps management in finding out the errors & frauds. Management can take corrective measures against these errors. Steps are taken so that they are not repeated again. This way it improves the quality of business process & improves its efficiency. Also the employees of business work properly due to the threat of auditing.

Assurance to investors

Auditing assures that each & every figure represented in the financial statement is correct. It helps in evaluating every figure of business books of accounts. Financial statements after being audited are considered trustworthy by investors. Investors are fully assured by these financial statements.

Checking Assets and liabilities

Auditing thoroughly evaluates the financial statements of the business. It helps in confirming the true value of assets & liabilities of the organisation. This helps in determining true financial position of the business. After that accordingly, proper plans can be made to achieve targets & goals.

Advantages of Auditing :-

1. **Ensures account correctness:**

Auditing conducts a detailed examination of all accounting books of an organization. It finds out the accuracy of financial records and ensures whether they fulfil all statutory requirements or not.

2. **Detects and prevent errors:**

It plays an efficient role in finding out errors and prevention of frauds. Auditing evaluates each financial transaction of business for checking if there is any mistake or not. This way it reduces the chances of errors and overall risk occurring due to such errors or frauds.

3. Helps in maintaining accounts regularly:

Maintenance of all account on a regular basis is another major advantage provided by the auditing process. It keeps a check on the regularity of account and raises questions if they are not maintained in an adequate manner.

4. **Easy procurement of loans:**

Auditing reports serves as a tool for easily acquiring the required funds from various financial institutions. These reports depict the true financial position of organizations to investors which helps them in deciding the credibility of concerned business organization.

5**. Keeps morale check:**

Auditing monitors the overall financial dealing of organizations. This prevents the working staff from committing any error and fraud. All employees work efficiently towards their role with a fear that all irregularities will be identified by auditing.

6. **Assists in decision making:**

It provides valuable information to managers for efficient decision making. Auditing is done by various experts of account and finance who have detailed knowledge of subjects, so they provide advice and resolves all problems.

7. **Stakeholder's confidence:**

Auditing statements enables in gaining the confidence of stakeholders. All stakeholders such as creditors, shareholders, banks, investors etc. have more confidence in audited financial accounts of the company.

Disadvantages of Auditing :-

Disadvantages of auditing are as follows:

1. **Costly:**

Auditing process puts a financial burden on organizations as it requires the huge cost to conduct an examination of all financial accounts. Business needs to pay large fees to auditing experts for their services.

2**. Rely on experts:**

Auditor is dependent on experts of various fields for conducting auditing process. For acquiring true information regarding the valuation of fixed assets and contingent liabilities, he needs to approach valuers, engineers and lawyers.

3**. Impossibility of checking all transactions:**

Another major drawback of auditing is that it is not always possible to check each financial transaction of organizations. Some organizations are too big and have a large number of transaction, where evaluating all of them become quite an impossible task.

4. **Unsuitable for small concern:**

Auditing may not be fruitful for small organizations where there are limited transactions. Their accounts can be evaluated without an audit program.

5. **Chances of fraud:**

Audit may lead to errors and frauds in a business. Audit staff may perform their task carelessly and present an inaccurate audit report. Also, there may be chances where staff auditing accounts may be harassed within the organization and may be forced to manipulate the figures.

Auditing - Basic Principles:-

Planning

An Auditor should plan his work to complete his work efficiently and well within time. To plan work accordingly, an Auditor handles the following −

- Accounting system and policies.

- Internal control system of organization.
- Determination of audit procedures and coordinating audit work.

Honesty

An Auditor must have impartial attitude and should be free from any interest. He should be honest and sincere to his work and he should do his work without any bias and prejudice.

Secrecy

An Auditor should keep confidential all the information acquired by him during his audit. He should not share the information with anyone without the permission of the client and that too the information can be shared with the client’s permission only when it is bound to be so.

Audit Evidence

An Auditor should adhere to substantive and compliance procedure for collecting audit evidences before conducting an audit. Through substantive procedures, an Auditor may collect evidences regarding accuracy, completeness and validity of data; and through compliance procedure, he may collect evidences regarding internal control system as used in the client’s organization.

Internal Control System

It is the primary responsibility of a company to keep adequate internal control system in his organization. On the basis of such internal control system, an Auditor can determine the nature, timing and audit procedure to be applied to conduct his audit.

Skill and Competence

Audit should be done by trained, experienced and competent persons and audit staff should be updated with all the developments in accounting, auditing and legal rules and regulations as amended from time to time.

Work Done by Others

An Auditor is permitted to rely on work done by others but he should exercise due diligence when referring to it. He should mention the source of reference thereof in his report.

Working Papers

An Auditor should prepare and preserve all the necessary documents as obtained during his audit. These documents can be used by him as audit evidences.

Legal Framework

All business activities should be run adhering to the rules and regulations stipulated in the legal framework. This is to safeguard the interests and rights of the interested parties.

Audit Report

On the basis of the review and assessment of the audit evidences, Auditor should express his opinion regarding financial statements of an organization −

- Financial statements are prepared using acceptable accounting principles.
- Financial statements comply all relevant statutory requirements.
- All material matters are disclosed and proper presentation of financial statements are done subject to statutary requirements.

Auditing - Audit Techniques

Evidences are very important for an Auditor to form an opinion regarding financial statements. If Auditor fails to collect proper evidence, it will reduce the reliability of audit report. The method of collecting evidence is called audit technique.

Following are a few important audit techniques −

Vouching

When the Auditor verifies accounting transactions with documentary evidence, it is called vouching. Through vouching, the Auditor verifies authority and authenticity of records.

Confirmation

Confirmation is a technique used by an Auditor to validate the correctness of the transactions; for example, an Auditor obtains written statement directly from debtors to confirm the debtors balance as appeared in the books of client.

Reconciliation

Reconciliation is a technique used by an Auditor to know the reason of differences in balances. For example, to know the difference in the bank book of the client and the bank balance as appeared in the bank statement or pass book, the Auditor prepares the reconciliation statement. The same method may be used for debtors, creditors, etc.

Testing

Testing is a technique of selecting representative transactions out of whole accounting data to draw a conclusion about all items.

Physical Examination

Physical examination requires verification and confirmation of the physical existence of tangible assets as appears in the Balance Sheet like cash in hand, land and building, plant and machinery, etc.

Analysis

Analysis is technique used by an Auditor to segregate important facts and to further study their relationship.

Scanning

By scanning of books of accounts, an experienced Auditor can identify those entries which would require his attention. It is also called scrutiny of accounts.

Inquiry

This method is used to collect in-depth information about any transaction.

Verification of Posting

To verify posting from books of original entry to ledger account and confirm the balance, an Auditor is required to verify the postings; for example, to verify a sale book, an Auditor may verify postings from the sale register to the sale ledger. He may further calculate balances of the sale register and the sale book.

Flow Chart

The Flow Chart technique is used by an Auditor to determine the stages of transaction and the generation of documents at all levels of transactions.

Observations

Through observation, an Auditor get an idea about reliability of the process and the procedure of an organisation.

Classification of Audit :-

1. **Audit by an outside person (Independent audit)**

- **Audit on the basis of organisation:**

Statutary audit :- An audit which is authorised and governed by law and which is made compulsory under any statute is called statutary audit
Non statutary audit :- when there is no statutary obligation on the part of the organisations to get accounts audited, this is known as non statutary audit.
Goverment audit :- the goverment maintains a seperate department, namely the accounts and audit department which is entrusted with the audit of its different departments and

offices. The comptroller and audit general of india is in charge of management and control of this department of various states.

- **Audit On the basis of time :-**

Continuous audit :- Continuous audit is an audit, which is conducted continuously throughout the year at regular or irregular intervals during the financial year.
Periodical audit :-Periodical audit is an audit, which commences after closing of accounts and preparation of final accounts and is carried out continuously till the conclusion of audit.
Interim audit :- an interim audit is that kind of audit which is conducted in between two annual audits with some interim purposes.

- **Audit on the basis of legal aspect :-**

Compulsory audit :- It refers to one which is made compulsory to be introduced by means of Act or Statute. In other words, the owner of the organisation will be bound to get their accounts audited.
Voluntary audit :- A voluntary audit is an audit, which is not compelled or mandated by law. It is an audit that is exercised by choice, hence the very essence of it being voluntary'.

- **Audit on the basis of nature and scope :-**

Complete audit :- when the work of audit is taken up at the close of the definite accounting period, it is called complete audit.
Partial audit :- when the audit is conducted on some of the records and books of a part or whole of the period, it is called the partial audit.

- **Audit on the basis of specific objective :-**

Cash transaction audit
Balance sheet audit
Standard audit
Cost audit
Management audit
Human resource audit
Social audit
System audit
Propriety audit
Performance audit
Tax audit
Farm audit
Special audit

2. **Audit by the employees of the concern :-**

- **Internal Audit :-** Internal audit is a system of audit to examine the accounts continuously throughout the year by specialist staff of the concern, who are appointed as paid employees, having no link with the accounts department.

Difference between statutary audit and non statutary audit :-

The main points of distinction are:

Statutory Audit:

1. It is compulsory.
2. The relevant statute or law determines the scope of work.
3. The academic or professional qualification is prescribed for the auditor.
4. The statute dictates the powers, rights and duties of an auditor.
5. The auditor has independence in status and in mental attitude.
6. The auditor is liable for negligence under the Common Law and for misfeasance under the relevant statute governing the audit.
7. The audit report is published for the public.

Non-statutory Audit:

1. It is voluntary.
2. The employer or partners determine the scope of work.
3. The auditor need not possess any academic or professional qualifications.
4. The agreement between an auditor and firm decides these matters.
5. The auditor does not enjoy such independence.
6. The auditor is liable for negligence only under the Common Law.
7. The audit report is made known to the employers or partners.

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