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*Topic- Auditing

* The word Audit is derived from Latin word “Audire” which means ‘to hear’.
* Auditing is the verification of financial position as disclosed by the financial statements.
* It is an examination of accounts to ascertain whether the financial statements give a true and fair view of financial position and profit or loss of the business.
* Auditing is the intelligent and critical test of accuracy, adequacy and dependability of accounting data and accounting statements.

*Meaning of Audit

* The audit is a methodical procedure ***of independently examining the financial information of an entity with the aim of giving an opinion on true and fair view.*** Here organisation refers to all the entities, **regardless of their size, structure, nature and form.**
* Auditing is a critical, unbiased investigation of each and every aspect of the transaction, i.e. vouchers, receipts, account books and related documents are verified, in order to spot the validity and reliability of the financial statement. Moreover, errors and frauds or deliberate manipulation in accounts or misappropriation etc. can also be detected through detailed scrutiny.
* The auditor will inspect the accuracy and transparency of the financial information, compliance with the accounting standards and taxes are properly paid or not.
* After the complete inspection of accounting books and financial records, he will give an opinion in the form of a report.
* The reporting on the true and fair view shall be made to the person who appoints the auditor.
* **The audit can be conducted internally and externally**. The task of internal audit is conducted by an ***internal auditor who is appointed by the management of the organisation for improving its internal control systems and accounting system. External Auditor is appointed by the shareholders of the company.***

* “Auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they purport to relate.”-L.R.Dicksee

* “Auditing is concerned with the verification of accounting data determining the accuracy and reliability of accounting statements and reports.” - R.K. Mautz

* “Auditing is the systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies and stated requirement.” -R.E.Schlosser

* Different authors have defined auditing differently,

* The objectives of the auditing have been classified under two heads:

1) Main / primary objective
2) Subsidiary/ secondary objectives

Main Objective: The main objective of the auditing is

* To find reliability of financial position and profit and loss statements.
* To ensure that the accounts reveal a true and fair view of the business and its transactions.
* To verify and establish that at a given date balance sheet presents true and fair view of financial position of the business and the profit and loss account gives the true and fair view of profit or loss for the accounting period.
* To be established that accounting statements satisfy certain degree of reliability.
* To form an independent judgement and opinion about the reliability of accounts and truth and fairness of financial state of affairs and working results.

*Objectives of Auditing

*Subsidiary objectives:

1. **Detection and prevention of fraud:** the one of the important subsidiary objective of auditing is the detection and prevention of fraud. Fraud refers to intentional misrepresentation of financial information.

Fraud may involve:

a. Manipulation, falsification or alteration of records or documents
b. Misappropriation of assets.
c. Suppression of effect of transactions from records or documents.
d. Recording of transactions without substance.
e. Misapplication of accounting policies

2. Detection and prevention of errors: is another important objective of auditing. Auditing ensures that there is no mis-statement in the financial statements.

Errors can be detected through checking and vouching thoroughly books of accounts, ledger accounts, vouchers and other relevant information.

* **Types of Errors**
* **A.** ***Clerical Errors :*** Clerical errors are those which result on ***account of wrong posting*** that is posting an item to a wrong account, totalling and balancing. Such errors may be subdivided into:
* (i) *Errors of Omission :* An error of omission takes place when a ***transaction is completely or partially not recorded in books of account.*** For example, goods purchased from Narendra Kumar were not recorded any where in account books.
* (ii) *Errors of Commission :* Errors of commission take place when **some transaction in incorrectly recorded** (wrongly entered) in books of account

For e.g. Error in writing amount in an account. For example, debiting Prem Chand' s Account with Rs. 107- instead of Rs. 100/-.

* B. ***Errors of principle*** : Errors of Principle take place ***when a transaction is recorded without having regard to the fundamental principles of book-keeping and accountancy.***
* For example if there is incorrect allocation of Expenditure or Receipt between Capital & Revenue
* **C. *Compensating Errors / off setting Errors* :-** Compensating errors arise 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 credit (or debit) side**.**
* **For example Anil's account was to be debited with Rs. 500, was credited for Rs. 500 similarly Sunil's account which was to be credited for Rs. 500 was debited for Rs. 500. Both these errors compensate each other's deficiency**

D. Errors of Duplication

* Such errors arise ***when an entry in a book of original entry has been made twice & had also been posted twice***.

Types of Frauds

* These are intentional errors and wanted misrepresentations and failure to disclose the materialistic facts to the transactions in the books of accounts. Such as

1. Misuse of Cash: Cash is the highly exploitation asset in the business, auditor check receipts and payments of cash in order to detect and prevent cash embezzlement (*Misappropriation)* of cash.

* Cash may be misappropriated by,
* (a) Omitting to enter any cash which has been received; or
* (b) Entering less account than what has been actually received; or
* (c) making fictitious entries on the payment side of the cash book; or
* (d) entering more amount on the payment side of the Cash Book than what has been actually paid.

2. Misappropriation of Goods: Fraudulent application of goods by those who handle them e.g. recording purchase of large quantities receiving less quantity & than receiving the balance amount privately.

Proper methods of keeping accounts in regard to purchases and sales, stock, periodical checking of stocks, will help to avoid misappropriation of goods.

***3. Fraudulent Manipulation of Accounts* /Forgery Vouchers:** These are the fake evidences produced to auditor in the process of auditing. Such must be identified by the auditor.

* **This type of fraud is more difficult to discover as it is usually committed by directors or managers or other responsible officials. That is why the auditor should be very careful in detecting such frauds. He should carry out the routine checking and vouching most carefully and make searching, tactful and intelligent enquiries**
* The accounts may be manipulated in a number of ways which are as follows:
* 1. by not providing any depreciation or less depreciation or more depreciation; or
* 2. by under valuation or over-valuation of assets and liabilities; or
* 3. by the utilization of secret reserves during a period when the concern has made less or no profit without disclosing that fact to the shareholders etc.
* In simple words:

According to the section 143 of companies act 2013,

* **Primary Objective** of auditing is to **report the owners** whether the financial statement provides true and fair view of financial matters of the company.
* **Secondary Objective** is to **Detection and prevention of frauds and detection and prevention of errors.**

*ACCOUNTING V/S AUDITING

Accounting	Auditing
1. Meaning	
Accounting means systematically keeping the records of the accounts of an organization and preparation of financial statements at the end of the financial year.	Auditing means inspection of the books of account and financial statements of an organization.
2. Governed By	
Accounting Standards	Standards on Auditing
3.Work performed by	
Accountant	Auditor
4. Purpose	
To show the performance, profitability and financial position of an organization.	To reveal the fact, that to which extent financial statement of an organization gives true and fair view.
5. Commencement	
Accounting begins where bookkeeping ends.	Auditing begins when accounting ends.
6. Period	
Accounting is a continuous process, i.e. day to day recording of transactions are done	Auditing is a periodic process.

7. Nature

It is concerned with finalisation of final accounts

It is concerned with establishment of reliability of financial statement

8. Objective

To ascertain trading results

To certify the correctness of financial statements.

9. Reporting

An accountant does not submit any report.

An auditor submits prescribed report.

10. Status

An accountant is an employee of an organisation.

An auditor is not an employee of an organisation.

11. Errors & Frauds

Accountant may commit errors and frauds

Auditor cannot afford to commit errors and frauds.

12. Qualfication

No formal qualification

Needs prescribed qualification.

Various classes of audit / classification of Audit

<u>On the basis of Time</u>

1) **<u>Interim audit:</u>** An audit is performed **in between two annual audits** is considered as Interim audit. It can be conducted as Quarterly or Half yearly. It may involve complete checking of accounts for a part of the year. Normally this audit is conducted in the large companies where huge amount of transactions are available for audit work.

It may be also conducted to enable the board of directors to declare an interim dividend

2) Periodical/Finial audit (Year end): Here the commencement of the audit work starts at the end of the financial year . After preparation of final accounts of the business the auditor is called to conduct an audit. Such type of audit is called as Finial Audit. This type of audit is best suited for small concerns, as in case of large concerns it takes more time to complete the audit if commenced at the end of the year. Suitable where chances of frauds are less.

3) <u>Continuous / Detailed audit</u> : A continuous Audit is where the auditor and his staff are constantly engaged in checking the accounts during the entire financial period or at regular or irregular intervals during the period.

Generally large companies where bulk transactions were involved will be subjected to continuous audit.

It involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole period of trading.

4) ***Balance sheet audit:*** It is complete verification of all items presented in the balance sheet. It includes verification & valuation of assets & liabilities appearing in the balance sheet. The auditor investigates regarding materiality, and statutory requirements. This type of audit is successful where the proper internal control system is exists, because under this type of audit the auditor might not follow the elaborate checking of transactions.

Classification based on organisational structure & Authority

A business undertaking may be owned, managed & controlled by govt. or private individuals , & may be operated in a corporate form or non-corporate form. The type of audits to be conducted for various organisations, therefore should fall under the following categories.

* **Statutory Audit**
* Is one that is authorised by and compulsory under a statute or law which lays down or prescribes in definite terms the nature, scope and extent of audit and also the auditor's qualifications, duties and rights, e.g., in the case of a company including a government company or public sector enterprise/undertaking and other organisations or public corporations governed by special statutes.

- Where undertaking are formed under the statute or laws, audit for such undertakings is made compulsory under the statutes that govern them
- An audit undertaken under any statute or law is called statutory audit
- Audit is compulsory under statute in the following cases:

* **Government Audit**
* The Government maintains a separate department in the name of accounts and audit department which performs the audit of its different departments and offices.
* Audit of Government departments performed under statutory regulations made compulsorily by government of India called as **Accounts and Audit Department General of India**. On the basis of these provisions the Government departments must conduct such audits. Only Officers of the Government can works for accomplish the audit of the Government departments

* The duties and liabilities of such auditors are not defined by statue. They are not public auditors and hence can not be appointed auditors for public concerns. They are meant for Government departments and as such, they work according to departmental rules and instructions.

Joint stock companies incorporated under the companies act , 2013

- The shareholders are the actual owners of a company & they appoint the directors to supervise overall affairs of the company.
- All joint stock companies are required to get their accounts audited by an independent auditor, so that the owners may get assurance about the reliability of the financial statements prepared by the mgmt.
- People invest in shares of a company on the **basis of profitability, ratio analysis & financial position of the company.**
- Persons who are affected by financial statements like financial institutions ,banks , trade creditors , income tax, excise and other revenue authorities also do rely on audited financial statements.
- In view of all above factors statute has made it compulsory for all joint stock companies to get their accounts audited.

Cooperative societies registered under the Cooperatives societies Act

- Every cooperative society has to get it registered with the Registrar of Cooperative societies of the state concerned under cooperative societies Act 1912.
- Being a registered body a cooperative society is also regarded as an entity distinct from its members.
- All members contribute capital of a cooperative society but mgmt. of its affairs is entrusted to a few members elected for this purpose.
- This substantiates the requirement of an independent financial audit of accounts of cooperative society
- The appointment of auditor for a cooperative society is made by the registrar of cooperative societies.
- The auditor conducts the audit & submits his report to the Registrar & to the society

Besides companies & cooperative societies Audit is mandatory requirement in respect of the following institutions.

a) Public & charitable trusts registered under the relevant Acts.
b) Banking companies governed by banking companies (Regulation) Act, 1949
c) Insurance companies governed by the insurance Act 1938
d) Public sector undertaking (PSUs),local authorities,& Govt. financial institutions established under the special Act or Law.

*Private Audit / Non Statutory Audit

is not obligatory under any legal provision; it depends on the discretion of the owners of a business or other interested individuals or private bodies and is governed by the terms of contract between the auditor and his clients.

It is not mandatory under the statute or law.

It is undertaken in view of several benefits they are as follows:

1. ***Audit of sole Proprietorship***

- **Audit of sole proprietor is optional**
- **This business is owned, managed & controlled by an individual.**
- **He individually decides whether to get the books of account audited or not.**
- **The auditor obtains clear instructions from the owner regarding the nature& scope of audit to be undertaken.**

2.Audit of partnership firm

Partnership Act 1932 does not require partnership firm to get their financial statement audited.

Still many partnership firms provide for audit of their books of account

The auditor is not appointed under any statute but by an agreement between partners.& auditor.

The auditor should draw attention on the following points.

a) Partnership Act , 1932
b) Partnership deed which is the most important document
c) Nature of business
d) Names & address of all partners
e) Capital introduced
f) Partners profit sharing ratios.
g) Interest on capital payable to partners , if any.

3. Audit of accounts of other entities

There are some other institutions where financial statements are not required to be audited by an independent auditor under any statute or law.

Viz. clubs, libraries, Hospitals, schools, colleges, other educational institutions & Hindu Undivided Family.

*Based on scope

1. Complete Audit

- the auditor is required to check each & every transaction record in the books of accounts.
- He has to examine each & every voucher, document or correspondence relating to the transaction.
- This type of audit is not suitable for large firms.

2. Partial Audit

- The auditor is not required to examine all the books of accounts.
- Only a part of the accounts or same transactions as desired by the clients may be scrutinized .
- Auditor has to state the area covered by the audit.
- This audit is not convenient when the audit is legally required

* 3. Detailed audit
* The business transactions are examined in detail by the auditor.
* Certain transactions are traced through various stages from the beginning to their end with the help of available evidence.
* This technique of examination is called **Audit In Depth**
* **Example detailed audit of purchase of goods for inventory would consist of tracing the transactions.**
* **Requisitioning the go requisitioned, ordering the goods,**
* **receiving the goods ordered & preparing the payment voucher**

*Qualities of an Auditor

The Auditor must possess the following qualities: (refer to the elaborated points)

1. Only the qualified chartered accountant can be appointed as auditor of a limited company.
2. The auditor must have thorough knowledge of principles and practice of all aspects of accountancy. He must be familiar with all systems of accountancy in use.
3. He should have adequate knowledge of financial management, industrial administration and business organization.
4. He must have thorough knowledge of audit case laws as per the various cases decide by the courts in and outside India.
5. He should be able to understand the technical details of business whose accounts he is going to audit.
6. An auditor must be honest i.e. He must certify that he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true.
7. He must act impartially and not influenced by others, directly or indirectly while discharging his duties.
8. He should be hard working, systematic and methodical.
9. He must have capacity to hear arguments of others.
10. He should have adequate skills and courage to write audit report correctly clearly and concisely.
11. He should not disclose the secrets of his client.

Advantages of Audit

* **1. Detection & prevention of errors & frauds become easier**
  - Errors & frauds can be located & rectified at an early & initial stage.

* **2. Audited accounting information**
  - Greater reliability & authenticity
  - Mgmt. exercises a great deal of subjectivity in preparing financial statements & allocating resources entrusted to it in operating the entity.
  - Audit provides reasonable assurance that Mgmt. representations on these activities are authentic.

* **3. Acceptability by the authorities**
  - Audited accounts are readily acceptable by the income tax , sales tax & other statutory body.

* **4.Professional advice available**
  - Independent auditors also render services other than auditing.
  - They do tax work, act as Mgmt. consultants advice on internal control system in operation & prepare reports required by govt. agencies

* **5.Speedy processing of loan**
  - Financial institutions consider audited accounts genuine & authentic & this helps them in speedy processing of loan proposals.
* **6.Settlement of disputes.**
  - In case of partnership firm dispute among partners over such matters as profit sharing , settlement of claim incase of retirement/death of a partner may be less likely to arise when accounts are duly audited. All partners can easily trust audited accounts.
* **7.Facilitates calculation of net worth & goodwill of business**
  - In case of Sale over of business as a going concern by other party, audited accounts carry greater reliability deciding out the net worth of business & goodwill.
  - A perspective purchaser of a business may place more confidence in audited accounts as evidence of past profitability
  - Auditing function therefore plays an important role in verifying whether an organisation is profitable or not or whether its financial position is sound or not.

* **8.Settlement of insurance claims**
* Audited accounts are likely to have more credibility & helps in early settlement of insurance claims in case of loss by fire,
* 9.Useful to compare the financial performance

* **10.Keeps accounts department vigilant**
* Regular audit of accounts keeps the accounts dept. not only up-to-date but also careful & vigilant.

* 11. **Identifies the weak areas**
* Reviews the internal control system & identifies the weak areas. Helps mgmt.
* to get over the weakness & achieve their goal within stipulated time & at reasonable cost.

* **Limitations of Auditing**
* 1. Lack of complete picture—The audit may not give complete picture. If the accounts are prepared with the intention to defraud others, auditor may not be able to detect them.
* 2. Problem of Dependence—Sometimes the auditor has to depend on explanations, clarification and information from staff and the client. He may or may not get correct or complete information.
* 3. Existence of error in the audited accounts—Due to time and cost constraints, the auditor can not examine all the transactions. He uses sampling to check the transactions. As a result, there may be errors & frauds in the audited accounts even after the checking by the auditor.

* 4. Exercise of judgement—The nature, timing and extent of audit procedures to be performed is a matter of professional judgement of the auditor. The same audit work can be done by two different auditors with difference in sincerity & personal judgement.
* 5. Diversified situations—Auditing is considered to be a mechanical work. Auditors may not be in a position to frame audit programme which can be followed in all situations.
* 6. Lack of Expertise—In some situations, an auditor has to take opinion of experts on certain matters on which he may not have expert's knowledge. The auditor has to depend upon such reports which may not be always correct.
* 7. Limitations of internal control—The auditor can only report on the truth and fairness of the financial statements. But other problems relating the management and control may not be possible to be covered by the auditor. Examples of such problems or limitations of internal control are cast-ineffectiveness, manipulations by management, etc.
* 8. Influence of management on the auditor—Tthe auditor is influenced by the doings of those in management. The reason is that he is appointed by the share holders and directors who pay him remuneration or fee

* **(i)** ***Integrity, Objectivity and Independence*****:**
* The auditor should be straightforward, honest and sincere in his approach to his professional work.
* **He must be fair** & must not allow prejudice or bias to overcome his objectivity.
* He should maintain an impartial attitude and both be, and appear to be free of any interest which might be regarded, whatever its actual effect on being incompatible with integrity and objectivity.
* It lays down standards of ethical conduct for auditors. It highlights the true nature of an auditor's function.
* Like a judge , an auditor has to form his opinion on the basis of the evidence rather than on the basis of pre-conceived notions.
* The standards of ethical conduct have been further detailed by the professional bodies as well as the relevant laws.

* **(ii) *Confidentiality*:**
* The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
* confidentiality is not only a matter of non-disclosure.
* It implies that the auditor should neither use nor appear to use the information acquired in the course of audit for personal advantage or for the advantage of third party.
* ***Under following two circumstances however information acquired during an audit may be disclosed by auditor to third party.***

1) ***Where disclosure is authorised by the entity under audit***
2) ***Where disclosure is required by a legal or professional requirement.***

* (iii) ***Skill and Competence*:**

a) The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.

b) The auditor requires specialised skills & competence which are acquired through a combination of general education, technical knowledge obtained through study & formal courses concluded by a qualifying examination recognised for this purpose.

* **(iv)** ***Work Performed by Others*****:**
* **A)** When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming & expressing his opinion on financial information.
* however , he will be entitled to rely on work performed by others provided he exercises adequate skill and care and is not aware of any reasons to believe that he should not have so relied (***there is nothing to doubt***).
* B) The auditor should carefully direct, supervise and review work delegated to assistants and obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.
* This principle deals with the auditor's duties & responsibilities when he

a) Delegates work to assistants.

b) Uses work performed by other auditors.

c) Uses work performed by experts.

When the auditor delegates work to assistants. He should carefully direct, supervise & review the work to ensure that the audit is conducted with professional care.

* **since he will continue to be responsible for forming and expressing his opinion on the financial information**.

* (v) ***Documentation*:**
* The auditor should document matters which are important in providing evidence that the audit was *carried in accordance with the basic principles*.
* Maintenance of adequate documentation (working papers) helps the auditor in proper planning, performance, supervision & review of audit
* Adequate documentation also provides an evidence of the audit work performed.
* (vi) ***Planning*:**
* Planning enables the auditor to conduct and effective audit in an efficient and timely manner.
* Primarily, ***planning should be based on the knowledge of the client's business.***
* Plans **should be further developed and revised as necessary during the course of the audit.**
* The following aspects should be covered in audit plan

a) Accounting knowledge of the business of the client.
b) Studying & evaluating the accounting system & related internal controls through compliance procedures.
c) Determining substantive procedures.
d) Laying down duties, time schedule etc. to ensure that the audit is properly coordinated

Audit plan should constantly reviewed & modified

* (vii) *Audit Evidence*:
* The auditor should obtain sufficient **(quantity)** appropriate **(quality)** audit evidence through the performance of compliance (internal control test) and substantive procedures (detail testing) to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financing information.
* *Compliance procedures mean the test designed to obtain reasonable assurance that internal control have been properly designed & operating*.
* (viii) *Accounting System and Internal Control*:

a) The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. ***Internal controls normally contribute to such assurance***.

b) The auditor should gain an understanding of the accounting system and related internal controls and evaluate the same to determine the nature, timing and extent of other audit procedures.

* **(ix)** ***Audit Conclusions and Reporting*****:**
* The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether:

(a) the ***financial information has been prepared using acceptable accounting policies*** which have been consistently applied;

(b) ***the financial information complies with relevant regulations and statutory requirements***;

(c) **there is adequate disclosure of all material matters** relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

* The auditor should contain a clear written expression of opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. *When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matters is to be made, the audit report should state the reasons therefore.*
* **An auditor is required to submit his report to the effect whether or not the balance sheet is a true and fair representation of the existing state of affairs of a business concern.**