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B.Com. Part-1
Auditing (Paper-II)
Unit-1
Introduction to Auditing

Meaning and Definition of 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 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. Different authors have defined auditing differently, some of the definition are:

“Auditing is an examination of accounting records undertaken with a view to establishment 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**

Objectives of Auditing

The objectives of auditing are changing with the advancement of business techniques. Earlier it was only to check the correctness of receipts and payments. The objectives of the auditing have been classified under two heads:

I. Main objective
II. Subsidiary objectives

I. Main Objective:

The main objective of the auditing is to find reliability of financial position and profit and loss statements. The objective is to ensure that the accounts reveal a true and fair view of the business and its transactions. The objective is 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. It is to be established that accounting statements satisfy certain degree of reliability. Thus the main objective of auditing is to form an independent judgment and opinion about the reliability of accounts and truth and fairness of financial state of affairs and working results.

II. Subsidiary objectives:

The subsidiary objectives of the auditing are:

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.

Classes of Audit

I. Based on ownership:

On the basis of ownership audit can be:-

1. **Audit of Proprietorship:** In case of proprietary concerns, the owner himself takes the decision to get the accounts audited. Sole trader will decide about the scope of audit and appointment of auditor. The auditing work will depend upon the agreement of audit and the specific instructions given by the proprietor.
2. **Audit of Partnership:** To avoid any misunderstanding and doubt, partnership audits their accounts. Partnership deed on mutual agreement between the partners may provide for audit of financial statements. Auditor is appointed by the mutual consent of all the partners. Rights, duties and liabilities of auditor are defined in the mutual agreement and can be modified by the partners.
3. **Audit of Companies:** Under companies Act, audit of accounts of companies in India is compulsory. Chartered accountant who is professionally qualified is required for the audit of accounts of companies. Companies Act 1913 for the first time made it compulsory for joint stock companies to get their accounts audited from a qualified accountant. A number of amendments have been made in companies Act, 1956 and 2013 regarding appointment, duties, qualification, power and liabilities of a qualified auditor.
4. **Audit of Trusts:** The beneficiaries of the trusts may not have access and knowledge of accounts of the trust. The trustees are appointed to manage and look after the property and business of the trust. Accounts of the trust are maintained as per the conditions and

terms of the trust deed. The income of the trust is distributed to the beneficiaries. There are more chances of frauds and mis-appropriation of incomes. In the trust deed as well as in the Public Trust Act which provide for compulsory audit of the accounts of the trust by a qualified auditor. The audited accounts of the trust ensure true and fair view of accounts of the trust.

5. **Audit of Accounts of Co-operative Societies:** Co-Operative societies are established under the Co-Operative Societies Act, 1912. It contains various provisions for the regulations and the working of these societies. Some of the states have adopted it without any change, while others have brought certain changes to it. The auditor of the Co-operative Society should have an expert knowledge of the particular act under which Co-operative society under audit is functioning. He should also study by-laws of the society and make sure that the amendments made from time to time in the by-laws have been duly registered in the Registrar's Office. Companies Act is not applicable to the co-operative Societies. The Registrar of co-operative societies shall audit or cause to be audited by some person authorized by him, the accounts of the society once in every financial year.
6. **Government Audit:** Audit of government offices and departments is covered under this heading. A separate department is maintained by government of India known as Accounts and Audit Department. This department is headed by the Comptroller and Auditor General of India. This department works only for the government offices and departments. This department cannot undertake audit of non-government concerns. Its working is strictly according to government rules and regulations.

II. Based on Time:

On the basis of time the audit can be of following types:

1. **Interim Audit:** When an audit is conducted between two annual audits, such audit is known as Interim audit. It may involve complete checking of accounts for a part of the year. Sometimes it is conducted to enable the board of directors to declare an Interim dividend. It may also be for the purpose of dealing with interim figures of sales.
2. **Continuous Audit:** The Continuous Audit is conducted throughout the year or at the regular short intervals of time.

   "A continuous audit 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." - T.R. Batliboi

   "A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or hiss staff attends at regular or irregular intervals during the period." -R.C Williams

III. Based on Objectives:

On the basis of objectives the audit can be of following types:

1. **Internal Audit:** It implies the audit of accounts by the staff of the business. Internal audit is an appraisal activity within an organization for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of operating nature.
2. **Cost Audit:** Cost Audit is the verification of the correctness of cost accounts and adherence to the cost accounting plans. Cost Audit is the detailed checking of costing system, techniques and accounts to verifying correctness and to ensure adherence to the objectives of cost accounting.
3. **Secretarial Audit:** Secretarial Audit is concerned with verification compliance by the company of various provisions o Companies Act and other relevant laws. Secretarial audit report includes:

a) Whether the books are maintained as per companies act, 2013.
b) Whether necessary approvals as required from central Government, Company law board or other authorities were obtained.

4. **Independent Audit:** Is conducted by the independent qualified auditor. The purpose of independent audit is to see whether financial statements give true and fair view of financial position and profits. Mainly it is for safeguarding the interest of owners, shareholders and other parties who do not have knowledge of day-to-day operations of organization.
5. **Tax Audit:** Now-a-days tax audit has become very important to ascertain the accuracy of tax related documents. Tax audit mostly covers income returns, invoices, debit and credit notes and various current and fixed assets. Tax audit is an innovation of 21st century. It has added one more chapter to the practice of auditing. Tax audit ensures the validity and credibility of tax related documents.

Audit Note book

Audit note book is a diary or register maintained by audit staff to note errors, doubtful quarries and difficulties. The purpose is to note down the various points which need to be either clarified with the client or the chief editor. The Audit note book is used for recording important points to be included in the auditor's report.

Contents of an Auditor's Note Book

a) A list of books of accounts maintained.
b) The names, duties and responsibilities of principal officers.
c) The particulars of missing receipts and vouchers.
d) Mistakes and errors detected.
e) The points which need clarifications and explanations.

f) The points deserving the attention of the auditor.
g) Various totals and balances.
h) The Points to be a part of auditor's report.

Advantages of Audit Note Book

Some of the advantages of the audit note book are:

1. It ensures the uniformity and helps in knowing the amount of work performed.
2. Important matters relating to the audit work may be easily recalled.
3. Facilities and preparation of the audit report.
4. In case of the assistant in charge is changed, no difficulty is faced in continuing the incomplete work.
5. The responsibility of the errors undetected can be fixed on clerk concerned.
6. The audit note book shows the extent of the interest and pain taken by the audit staff. It helps in their appraisal.
7. It ensures that the audit programme has been sincerely followed. Deviations can be noticed.
8. It is reliable evidence in the court of law, if an auditor has to defend himself.

Audit Programme

Audit programme represents an outline of procedure to be followed to support an opinion on financial statements. It is the auditor's plan of action. It provides a plan of work of examination and a set of audit procedures.

According to *Megis*, An audit programme is a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required.

According to *holmes*, Audit programme is a flexible planned procedure of examination. Thus audit programme is a planning of audit by auditor so that he may be able to complete his work in a diligent manner and complete the work without loss of time.

Advantages of Audit Programme

Some of the important advantages of thee audit programme are:

a) It enables the auditor to keep in touch with the work done and general progress of the work.
b) The auditor can be certain that the audit staff will cover whole of the ground.
c) It will help the audit assistants to know their duties.
d) It helps to increase the efficiency of audit assistants.
e) Fixing of the responsibility of audit assistants becomes easier.
f) It provides a check against the possibility of certain important items requiring verification which are being omitted.
g) Continuity is not lost even if the person on the duty is changed.

Differences between Book Keeping, Accountancy and Auditing

Following are the differences between book keeping, accountancy and auditing:

1. Book keeping as an art of recording the business transactions in the books of original entry and the ledgers. Accountancy means compilation of accounts in such a way that one is in position to know the state of affairs of the business. The auditing means the verification of vouchers to find out their accuracy and give true and fair view in respect of final accounts.
2. The primary work is done by the book keeper and accountant while finishing touch is given by the auditors.
3. Where the work of an accountant ends, the work of auditor begins.
4. A book keeper and an accountant has to record the transaction in the books of accounts while an auditor has to check and verify such transactions and accounts and send a report to the persons who appointed him.
5. The book keeper or the accountants are the employee of the business firm while the auditor is an independent identity.
6. The accountant can give the information to the management as per the records maintained by them. Normally, he does not give and suggestion or advice to management while the auditor can give suggestions or advice on the basis of their finding from the accounts records.
7. Auditor should be a qualified accountant i.e. chartered accountant but in case of accountant it is not compulsory. He/she may or may not be a chartered accountant.

Qualities of an Auditor

What are Qualities of An Auditor? As we know that an auditor is a watchdog means that he appointed to look after the interest of shareholders or owners of the business. A watchdog looks after the property of the owner. It is the qualities of an auditor to protect the property of the owners. He must inform the shareholders when their rights are affected by wrong deeds of management. The auditor must try his best for detecting errors and frauds in order to protect the rights of shareholders. Moreover, an auditor is not a bloodhound. He should not protect management who has been found guilty of committing errors and frauds. He cannot show his favor towards those who are responsible for negligence and manipulation of accounting records. He has the right to report the matter to shareholders in case the management fails to protect rights of shareholders.

In case of International Laboratories Ltd. vs, Dewar it was held that while auditor may be only a watchdog. He will not have performed the function of his office if one how; he retreats under the barn or if he confines his protest to a fellow watchdog. The auditor is not free from liability relating to errors and frauds in the- books of accounts or financial statements. An auditor is a professional accountant so he owes his duty of reasonable care and skill in the conduct of an audit. He must check internal control system then he should start his audit work. He must verify assets and liabilities personally. He must check that financial statements conform to generally accepted accounting principles. In case of any doubt relating error or fraud, he should investigate the matter in depth to clear it.

The standard of audit work has been changed after the case of the McKesson and Robbins in the United States of America in 1938. Now auditor must be present at the time of stocktaking. He can examine whether the procedure followed for stocktaking is proper. If he is not satisfied he can mention the fact in his report. No doubt auditor 'is not a bloodhound, He cannot loot the property of the business for his personal benefit. He cannot allow management to misuse the property. He must use reasonable skill and care to locate errors and frauds in order to meet the requirements of an audit. The qualities of an auditor may be discussed in two categories:

I. Professional Qualities

1. **Accounting:** The auditor is an expert in the field of accounting. He knows the principles, methods, and techniques of accounting. It is a process that goes on for the whole year. The accounting system includes personnel, procedures, records, forms, and devices used by any business.
2. **Auditing:** The auditor is an expert in the field of auditing. He knows the rules and regulations often audit. He has practical experience in the field of auditing. The auditor knows the checking of financial statements records and performance of any concern.
3. **Company Law:** An auditor has full knowledge of Companies Ordinance 11984, Companies Rules 1985, Modaraba Companies Ordinance 1980, Modaraba Companies Rules 1981, and Banking Companies Ordinance 1962. The auditor carry examine the statements in the light of these rules.
4. **Mercantile Law:** An auditor is an expert in the Mercantile Law. He has complete knowledge of Contract Act 1872, Sales of Goods Act 1930, Negotiable instruments Act 1881, Partnership Act 1932, Insolvency Act, Transfer of Property Act and Common Carrier Act.
5. **Taxation Laws:** The knowledge of taxation is essential for professional auditor. He knows Income Tax Ordinance.2001, Sales Tax Act, Gift Tax Act, Excise, and Customs Act, He knows the rates of Tax.
6. **Business Organization and Operation:** The auditor must know organization structure and operations of the business. Placement of Workers on the job is organizational structure. He should know the working of various departments of the business.
7. **Budget Preparation:** The auditor must be expert in preparing budgets. The figures are collected from past year. The estimates are established for the next year. The various budgets are prepared for all functions of the business concern.
8. **Electronic Data Processing:** The auditor must be expert in electronic data processing. The computers are used in business for accounting and other functions. The auditor must have the training to handle data through computers.

9. **General Knowledge:** The auditor must have knowledge of general' science. He must be aware of economic and political conditions. He should remain in touch with the latest knowledge affecting business concerns.

II. PERSONAL QUALITIES

1. **Tact:** The auditor needs technical information to comment and criticize policies of management. When any information is missing he can collect such information with argument and debate without offending them.
2. **Honesty:** The auditor must have high moral standards. It' is his duty to report true and fair view of business matters. He must be straightforward, and honest in his professional work.
3. **Independence:** The auditor must be independent at the time of programming, investigation, and reporting. Other people do not influence him directly or indirectly.
4. **Vigilance:** The auditor is Vigilant about activities of accounting and audit staff. He can discover errors and frauds due to vigilance. He has an alert mind to watch audit work.
5. **Judgment:** The auditor must have judgment for Selection depreciation, provision for bad debts, and inventory can apply professional knowledge to make decisions.
6. **Leadership:** The auditor is a leader of an audit team. The senior and junior audit clerks are working under his leadership- As team leader; he can guide the auditors through demonstration.

Advantages of Auditing

Importance of auditing can be judged from the fact that even those organizations which are not covered by companies Act get their financial statements audited. It has become a necessity for every commercial and even non-commercial organization. The importance of auditing can be summed in following points:

a) Audited accounts help a sole trader in knowing the value of the business for the purpose of sale.
b) Dispute over correctness of profits can be avoided.
c) Shareholders, who do not know about day-to-day administration of the company, can judge the performance of management from audited accounts.
d) It helps management in detecting and preventing errors and frauds.
e) Management gets advice on financial affairs from the auditors.
f) Long and short term creditors depend on audited financial statements while taking decision to grant credit to business houses.
g) Taxation authorities depend on audited statements in assessing the income tax, sales tax and wealth tax liability of the business.
h) Audited accounts are useful for the government while granting subsidies etc.
i) It can be used by insurance companies to settle the claims arising on account of loss by fire.

j) Audited accounts serve as a basis for calculating purchase consideration in case of amalgamation and absorption.

k) It safeguards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

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