

Introduction to Auditing

Meaning:

The word "audit" is derived from the 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 and dependability.

Definition:

The Institute of Chartered Accountants of India in its publication of Auditing and Assurance Standards (CAAS-11): Basic principles Governing and Audit (CAAS-1) describes audit as "The independent examination of financial information of any entity, whether profit oriented or not and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon."

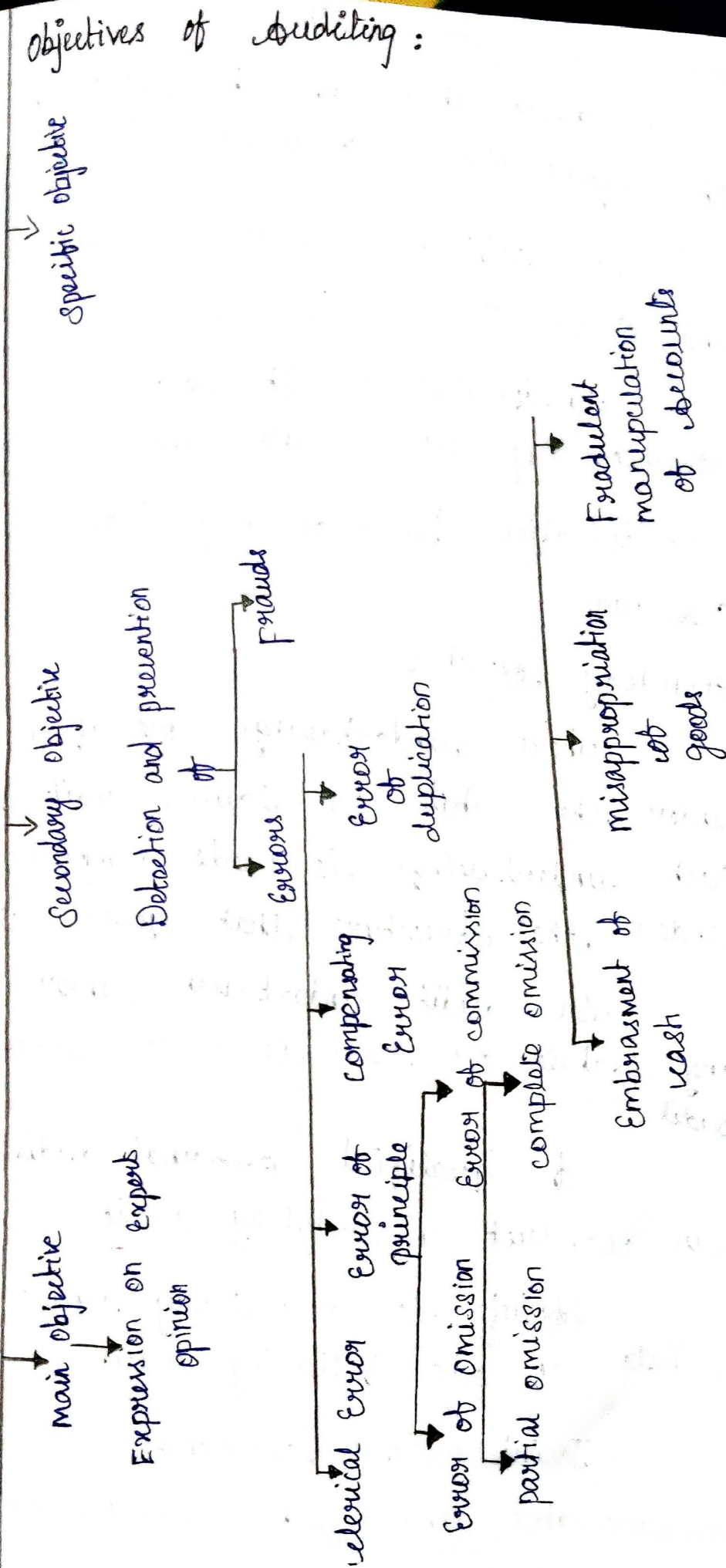
Monetary, a leading American accountant defines "auditing is a systematic examination of the books and records of a business or other organizations in order to ascertain or verify and to report upon the facts regarding its financial operations and the results thereof."

Accounting - Definition

According to American Institute of certified public accountants "Accounting is the art of recording, classifying and summarising in a significant manner in terms of money, transaction, and events which are in part at least of a financial character and interpreting the result thereof."

Thus accounting is the art of recording, classifying, summarising, analysing and interpreting the financial transaction and communicating the results thereof to the interested person.

Objects of audit



Classification of audit :

Classification on the basis of the organisational structure.

Classification based on the timing and scope of audit procedures.

Classification on the basis of specific objectives behind audit.

Classification based on organisational structure

Statutory audit :

Where undertakings are formed under the statute or laws, audit for such undertakings is made compulsory under the structure that govern them.

An audit undertaken under any statute or law is called statutory audit.

A qualified external auditor can conduct a statutory audit.

Audit is compulsory under statute in the following laws

Joint stock companies
Incorporated under the companies act 1956.

The audit of a Joint stock company is compulsory under the provision of companies Act 1956.

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 management.

co-operative societies registered under the co-operative societies Act 1912.

Every co-operative society has to get it registered with the Registrar of co-operative societies of the state concerned under the co-operative societies Act 1912. Registrar of co-operative society appoint an auditor, he may conduct audit on behalf of the registrar and submit the report to the Registrar.

Private Auditor :

Private audit is one that is not mandatory under any statute or law. It is undertaken by the enterprise in view of the several benefits resulting from it.

Types of Private auditor :

audit of sole proprietorship

optional

auditor can conduct audit after getting information from sole proprietor.

Audit of partnership firm:

The partnership Act, 1932 does not require a partnership firm to get their financial statements audited.

Some partnership firm are conducting audit of their books of accounts.

Audit of accounts of other entities:

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

- Clubs, libraries, hospitals, school, college, other educational institutions & HUF.

Government Audit :

The government offices, departments, undertakings registered as companies, are also subject to independent financial audit. Usually a statutory auditor, appointed by the central government on the advice of the comptroller and auditor general of India, audit accounts of government companies.

I Main objective:

✓ Expression of expert opinion:

An entity prepares balance sheet to portray its financial position. It also prepares P&L account to disclose the operating results of the period covered in the statements. The auditor checks them in a careful manner with utmost diligence and professional competence. Based on his checking, he expresses his opinion about the quality of financial statements concerning proper disclosure of facts in the financial statements and the truth and fairness of the financial position and operating result of the enterprise.

II Secondary objectives:

i) Detection and Prevention of Errors:

Error are unintentional mistakes in the financial statements, arising from inaccuracies in recording, matching or preparing financial statements.

Types of Errors:

Error of omission

Error of commission

Error of principle

Compensating Error or off-setting Error

Error of Duplication

Error of omission :

The error of omission is one where a transaction has not been recorded in the books of account either wholly or partially. E.g. forgetting to record a sale, failing to adjust inventory.

Complete omission :

A transaction is entirely / mistaking from the accounting records, meaning it was not recorded at all.

That is forgetting a transaction completely. It will not affect the total of trial balance.

Partial omission :

Recording only the debit side of a transaction, or credit side of the transaction. Only part of the transaction is recorded. Such as forgetting to include the amount of a sale or neglect to enter specific detail of an expenses.

Error of commission :

When a transaction has been recorded but has been wrongly entered in the books of original entry or posted in the ledger.

characteristics:

Incorrect recording
wrong amount
wrong account

Error of commission do affect the accuracy of financial records, they typically don't cause the trial balance to be out of balance.

ii) Error of principle:

Such error arises when the entries are not recorded according to the fundamental principles of accountancy.

E.g. Wrong allocation of expenditure between capital and revenue, ignoring the outstanding asset and liabilities.

iii) Compensating errors (or) offsetting errors:

It is the error which is counter balanced by any other error or errors.

E.g. if A's account was to be debited for Rs 100 but was debited for Rs 10 while B's account which was made to be debited for Rs 10 was debited for Rs 100.

iv) Error of Duplication:

Such error arise when an entry in a book of original entry has been made twice and has also been posted twice

Detection and prevention of Fraud:

A fraud is an error committed intentionally to deceive / to mislead / to conceal the truth or material fact. Frauds may be of three types.

Misappropriation of cash:

This is one of the major frauds in any organisation and normally occurs in the cash department. This kind of fraud takes place either by showing more payments or recording less receipts.

The cashier may show more expenses than what are actually incurred and may misuse the extra cash.

E.g. Showing wages to dummy workers.

Cash can also be misappropriated by showing less receipts.

Misappropriation of Goods:

This type of fraud is very difficult to detect especially when the goods are less bulky and are of low value.

Proper methods of keeping account in regard to purchase and sales, stock taking, periodical checking of stock, comparing the percentage of gross profit

to sales of two periods, necessity for correction will help to avoid this type of fraud.

Fraudulent manipulation of accounts:

Showing more profits than what actually they are

Showing less profit than what they are

The position of the auditor in regard to error and frauds can be summarised as follows:

It is the responsibility of management to prevent error and frauds.

The auditor is not liable for any subsequent discovery of misstatement of financial information resulting from error and frauds if he carried out his duty according to the generally accepted auditing practices.

If he discovers any error or frauds during his audit, he must see that the error are corrected and the effect of fraud on financial information of the financial statements is properly reflected.

The auditor need not sniff for error and frauds.

iii) Specific objectives:

Some of the Specific objectives are:

In operational audit, the aim of audit is to evaluate the existing operations of the entity in order to make a report on the proper ascertainment of cost of production of goods and services.

Distinction Between Auditing and Accounting.

	Accounting	Auditing
Definition	Accounting is the process of classifying, recording, interpreting, & summarising financial statements and transactions to determine the actual financial position of an organisation.	Auditing is the process examining the financial statements and records of an organisation to find discrepancies during the process of recording of transaction and to verify the accuracy of the records.

purpose	Accounting is done with the purpose of reflecting the actual position, performance and profitability of the business or organisation	Auditing is done to verify the accuracy of records and statements presenting by accounting.
objective	To determine the profit and loss on the financial position of an organisation for a period.	To determine the correctness and accuracy of all the recorded transaction.
period	Accounting is done daily, as transactions happen on a daily basis.	Accounting is a periodical assessment and is done on a monthly, quarterly or yearly basis.
Responsible person	Accounting is done by accountants	Auditing is done by Auditor
Initiation	Accounting starts at the end of bookkeeping	Auditing at the end of the accounting.
Concentration	Concentrates on the current financial activities and transaction	Concentrates on the past financial statements.
Scope	All records, transaction and statements having financial implications.	Final financial records & statements

Detail used	Captures all details related to financial records and transaction	uses financial records & statements on a sample basis
Governing standards	Governed by accounting standards	Governed by standard on Auditing.
carried out by	By internal employee	By external person or independent agency.
Appointment & removal	Accountants are appointed and removed by the management.	Auditor are appointed and removed by the shareholder.
Remuneration	Salary	Auditing fees
Deliverables	financial statements P&L A/c Balancesheet Income statements	Auditing Report
Report Submitted to	Management	Shareholders
Suggestions	Accountants can make suggestion for improving the accounting and related activities.	Auditor usually do not make suggestions.
Liability	Liability ends with the preparation of the accounts	Liability ends after preparations and submission of the audit report.

meetings	Accountants do not attend Shareholder meetings.	Auditor can attend Shareholder meetings.
prosecution for misconduct	Accountants are not usually prosecuted for professional misconduct.	Auditor can be prosecuted for professional misconduct.

Advantages and Limitations of Audit:

Advantages:

Detection and prevention of Error and Frauds become easier.

Error and frauds can be detected and rectified at the earliest with the help of auditing.

Audited accounting information :
reliability and authenticity

- An audit provides reasonable assurance that management's representations of preparing financial statements and allocating resources are authentic.

Acceptability by the authorities:

Audited accounts are readily acceptable by the Income tax, Sales tax and other authorities.

Professional advice available:

Independent auditor also render services other than auditing. They do tax works, act as management consultants

advise on internal control system in operating business and prepares reports required by government agencies.

Speedy processing of loan:

Financial institutions consider audited accounts genuine and authentic and this helps them in speedy processing of loan proposals.

Settlement of Disputes:

In case of partnership firm, when disputes arises that partners can easily trust audited accounts.

Facilitates calculations of net worth and goodwill of business:

In case of sale or take over of business as a going concern by other party, audited accounts carry greater reliability to deciding out the networth of the business and goodwill.

Settlement of insurance claims:

Audited accounts are likely to have more credibility and this ~~type~~ help in early and easy settlement of insurance claims.

useful to compare the financial performance :

Audited financial statements all concluded reliable to compare the financial performance of a business concern over the year.

keeps accounts department vigilant :

Regular audit keeps the accounts department upto date but also careful and vigilant.

Identify the weak areas :

Audit reviews the internal control system of the auditor and identifies the weak areas.

Limitations of Audit :

Auditor has to depend on the books of accounts and records produced before him by the management of the organization. The accounts and records may be biased.

Auditor may not traceout all types of error, misappropriations and manipulation, especially those ~~igno~~ ingeniously perpetrated.

If any officer intentionally does not give the true and fair view the audit work may not reflect true result.

The information and explanations collected by the auditors may not be correct. In such situations audit report also may be incorrect.

Influence of management is another limitation. Though, an independent auditor is appointed by the Shareholder, he depends on management for his remuneration. So there may be close conduct between them.

Scope of Audit :

Scope of audit refers to its Subject matter. It includes its area of operations, various aspects to be covered under the audit and the requirement of the ~~statements~~ relevant legislations.

Scope of audit - Auditing and Assurance Standards - 2 (AAS 2)

The audit should adequately cover all aspects of the enterprise, which are relevant to the financial statements, under audit.

The auditor should be reasonably satisfied that the information contained in the accounting records all reliable and sufficient for the preparation of financial statements in respect of which he is to form his opinion.

He should also see that the disclosure of information is as per the legal requirements, if any.

The reliability and sufficiency of the information will be assured.

The propriety of disclosure of information in the financial statements should be determined.

The auditor with a view to form his opinion on the financial statements follows procedures so as to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results.

Classification based on Timing & Scope of Audit procedures:

Continuous Audit:

Under this, the auditor is required to examine the books of accounts of a business concern at regular

intervals. by say weekly, fortnightly, quarterly or as per the requirements of the management and scope of audit. It is also known as running audit.

Internal Audit:

It is an audit conducted within the organisation by an internal auditor appointed by the management of an enterprise.

To ascertain whether all the prescribed rules, regulation, policies, procedures and principle have been followed or not.

To check whether existing internal control are adequate and effective.

To ensure that all the assets of the organisation are safeguarded against any probable misues.

To highlight the weak area of the organisation & give suggestions.

To check whether working of the organisation is smooth, effective and efficient.

Interim audit:

It related to an interim ^{period} audit and not to the full accounting year. It is conducted between two regular audits. It lies between final audit and continuous audit. It is initiated in order to know the reliability and accuracy of financial statements of the business for a part of the year.

Final audit or periodical audit:

It is the audit where the auditor undertakes the audit work only at the end of the financial year. Here, the audit work commences after all the accounts are closed and Balance Sheet and Trading and P&L accounts are ready, the auditor visits his client only once a year and complete the entries work at one stretch.

Balance sheet audit:

It is originated in the US, which implies a critical view of balance sheet. Here the balance sheet figures are taken and authentication is checked.

Classification based on specific objectives

Cost Audit:

The verification of cost accounts and a check on adherence to the cost accounting plan.

Special Audit:

According to Sec 233-A of Companies Act, 1956 the central Government may at any time order or direct a Special audit either chartered accountant or the company's statutory auditor may conduct this special audit.

Tax Audit:

Income Tax Act, 1961 provides for compulsory tax audit of the books of account of every person carrying on business or profession with turnover or gross receipts in receipts of such business Rs 40 lakhs, in case of profession, exceeding Rs 10 lakhs in any previous year.

Management Audit:

The critical and analytical examination of the performance of different managerial function in an organisations.

Operational Audit:

It aims at improving the overall performance of a business enterprise by improving future business operations carried by overall performance.

Marketing Audit:

It is the audit of marketing situations of a business undertaking. It is very popular in the US and European countries.

Environmental Audit:

The process to examine the effects good or bad of the operations of an enterprise on the environment.

Social Audit:

Enables the organisation to assess and demonstrate its social, economic and environmental benefits & limitations.

HR Audit:

Review an organisation's policies and practices concerning human resources.

Energy Audit:

It implies a critical review of utility energy data for all fuels, including electricity, natural gas, fuel oil and any other delivered fuels.

Audit of Banking:

All public sector banks are supposed to have their financial statements audited by statutory auditor irrespective of their size and volume of operations. RBI has certain tight norms for selection of central statutory auditor for the public sector banks & financial institutions.

Objectives of Bank Audit:

According to Section 30(1) of the act, balance sheet & profit & loss account of banking companies as well as nationalised banks are required to be audited by a person duly qualified to be an auditor of companies.

Steps:

Preliminary work

Evaluation of internal control system

Preparation of audit programme.

Execution of audit work.

Preparation & Submission of audit report.

Preliminary work:

The auditor of a bank should familiarise himself with the relevant provisions of applicable laws and ascertain the scope of his duties and responsibilities in accordance with such laws. He should well acquainted with the provisions of the Banking Regulation Act 1949. He should get full knowledge about the bank and its working.

Evaluation of Internal control system:

Every transaction should be checked and authorised by some responsible official before it actually takes place.

Every transaction should be entered in the books before the next transaction take place.

The routine procedure should be such as to prevent and detect errors and frauds in the normal course.

There should be a regular as well as surprise check by inspector and internal auditor, who should constantly review the workings.

Preparation of Audit programme:

The audit should prepare an audit programme for substantive testing which should adequately cover the scope of his work.

Execution of audit work:

The auditor should ensure that the work is executed in accordance with the audit programme. Thus should be adequate documentation of the work performed by the auditor.

Preparation and Submission of audit report:

This is the end product of the audit as it is the audit report that through which the observation/comments of the auditor on the financial statements are conveyed.

Audit of Insurance companies:

Insurance is a contract of indemnity between insurer and insured. The insurance may be classified into life insurance and non-life or general insurance.

Insurance companies are regulated by IDRA

The following enactments matter for the general insurance companies

The insurance Act 1938

The IDRA Act 1999

IDRA Regulation 1999

The General Insurance Business (Nationalisation Act) 1972

The companies Act 1956.

Audit of Accounts:

The accounts of the insurer are to be audited by a chartered accountant as provided in section 12 of the insurance Act 1938. Where the insurer is a company and hence is subject to statutory audit, the accounts shall be audited in term of previous provisions of the companies Act 1956. The auditor shall have right and duties as provided in the companies Act 1956.

The schedule of IDRA preparation of financial statements and Auditor's Report of insurance companies) Regulation 2000 Specifies the matter to be set out in Auditor's Report. They are:

Fact part

opinion part

The Auditor shall further state that
A certificate from Auditors

Fact part - contains :

That they have obtained all the information & explanation

whether proper books are maintained
whether proper return audited or not
whether actual valuation of liabilities is duly certified.

Opinion part :

It includes whether balancesheet, financial statements, Investment have been prepared duly following all the provisions of the Act. Accounting policies selected by the insurer are appropriate.

The Auditor shall further state that :

They have reviewed the management report & thus is no apparent mistake.

The insurer has complied with the term and condition & registration.

Certificate from Auditor in Respect the following :

Auditor will provide certificate regarding they have verified cash balance, & the Securities relating to the insurer's loan provision and life insurance and investment.

Have verified the investment & transaction

Have verified no contravention happened with respect to asset of the policyholder funds.

Non-profit organisations and charitable societies:

Non-profit organisations & charitable trusts:

Non-Profit organisation is a specific kind of organization which aims at solving social cause and serving people at large.

The source of revenue in such type of organisation is by way of donations, charity programmes, fund raising events or fees charged to people for becoming member of such organisation.

Eg. Health care sector, environment, religious acts.

Purpose of Audit:

The main purpose of audit of non-profit organizations is for verifying the accuracy and fairness of the financial data present in the financial statement. This analysis helps a chartered Accountant to give an opinion based on the observation

made with proper implementation of defined set of accounting and auditing compliance.

Points for smooth and effective Audit

Review of Accounting practices:

Ensuring that the practices being made are as per the defined practices and are ethical.

Evaluate financial Reports:

To ensure no error in the financial records.

Analysis management of contributions:

To ensure that the funds which have been utilised are spent on the stated cause by the organisations.

Test Internal control:

To ensure internal controls is effective.

check cash flow projections:

Verify each and every inflow and outflow of cash in the organisation.

Review policies & Procedures:

The policies and procedure adopted all verified.

charitable trust & organisations:

Charitable Societies are organisations whose purpose is freedom and society's well-being. They help in the common good in fields of education, religion etc. The audit of charitable organization comes under from 102 and 10BB.

For a charitable Society to be audited the following requirements need to be fulfilled.

1. If society's total income is not more than the said maximum amount in the prior year, then no audit is needed.

2. If it is found that total income does not pass limit of maximum expenses, then no income tax needs to be paid.

3. If the income of a charitable Society comes under section 1101A or clauses 23, 23AA 23C, then their donation qualify for the deduction.

Auditor duty:

1. To keep track of nature and purpose of donations made by regular donors.

2. To obtain verification of amount of subscription.

3. To check funds received for specific purpose are used for the same.

4. To check the accounting treatment to be conducted.

5. Should verify subscription not received & last year's subscriptions.

6. The legacies should be verified.

~~Attest~~