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SECTION-1 (AUDITING)

INTRODUCTION TO AUDITING

STRUCTURE:

1.1 OBJECTIVES

After studying this unit you will be able to understand

a. the evolution of auditing

b. the objects of auditing

c. the advantages and disadvantages of auditing

d. detection and prevention of frauds and errors

e. limitations of auditing

1.2 INTRODUCTION -AN OVERVIEW OF AUDITING:

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the barfly makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions

As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.3 ORIGIN AND EVOLUTION

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them

Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances.

The original objective of auditing was to detect and prevent errors and frauds

Auditing evolved and grew rapidly after the industrial revolution in the 18th century With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.

The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

In India the companies Act 1913 made audit of company accounts compulsory

With the increase in the size of the companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts

The companies Act.1913 also prescribed for the first time the qualification of auditors

The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the. accountants and auditors in the day to day work

The later developments in auditing pertain to the use of computers in accounting and auditing.

In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

1.4 DEFINITION

The term auditing has been defined by different authorities.

1. Spicer and Pegler: "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

2. Prof. L.R.Dicksee. "auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate.

3 The book "an introduction to Indian Government accounts and audit" "issued by the Comptroller and Auditor General of India, defines audit “an instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor."

1.5 FEATURES OF AUDITING

a. Audit is a systematic and scientific examination of the books of accounts of a business;

b. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.

c Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

d. Audit is a critical review of the system of accounting and internal control.

e. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

f. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

g The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

1.6 OBJECTIVES OF AUDITING

There are two main objectives of auditing. The primary objective and the secondary or incidental objective.

a. **Primary objective –** as per Section 227 of the Companies Act 1956, the primary duty (objective) of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company's state of affairs and the profit and loss A/c gives a correct figure of profit of loss for the financial year.

b. **Secondary objective –** it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objective of auditing are:
   i. Detection and prevention of Frauds, and
   ii. Detection and prevention of Errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated.

Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. Clerical errors.

1.7 EXPRESSION OF OPINION

When we speak of the objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exists as to distort what the accounts should really convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statement in such a way as to enable the reader of the accounting statement to form a correct view of the slate of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's Case* as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective; it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statement show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors of frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston*

Cotton Mills Co.

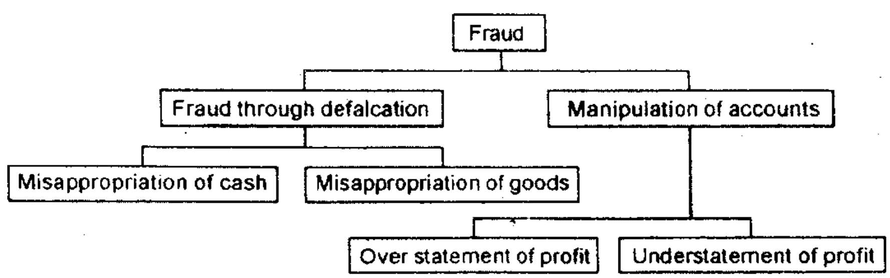
1.8 DETECTION OF FRAUD & ERRORS

The term fraud means the willful misrepresentation made with an intention of deceiving others. It is a deliberate mistake committed in the accounts with a view to get personal gain. In accounting, fraud means two things.

a. Defalcation involving misappropriation of either cash or goods; and

b. Fraudulent manipulation of accounts not involving defalcation.

1.8.1. FRAUD COVERS THE FOLLOWING



1.8.2 FRAUD THROUGH DEFALCATION.

Following are the methods of defalcation involving misappropriation of cash or goods

1 By misappropriating the receipt by not recording the same in the cashbook

2 By destroying the carbon copy or counter foil of the receipt and misappropriating the cash received

3 By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book

4 By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.

5 By omitting to record cash donations received by non-profit making charitable institutions

6 By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.

7 By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.

8 By adopting the method of "teeming and lading" or "lapping process". Under this method cash received from one debtor is misappropriated and deficiency in that debtors account is made good when another payment is received from second debtor by crediting the second debtors account less by that amount. This process is carried out round the year.

9 By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.

10 By misappropriating the sale proceeds of VPP sales or sales of goods on approval basis by treating the transaction as goods received or not approved.

11 By under casting receipt side total of the cashbook

12 By recording fictitious or bogus payments

13 By recording more payments than actual amounts paid by altering the figures on the vouchers.

14 By showing the same payment twice.

15 By showing credit purchases as cash purchases and misappropriating the amount

16 Recording personal expenses as business expenses

17 By not recording discounts and allowances given by the creditors and misappropriating the amounts

18 By overcasting the payment side total of the cashbook

19 Recording fictitious and inflated purchases and misappropriating that amount.

20 By suppressing the credit notes for returns and showing the full payment to creditors.

21 By including the names of dummy workers or the workers who have? The job in the wage sheets and misappropriating the amount.

22 By over casting the total of wages sheets and drawing that amount for misappropriation.

23 By misappropriating the undisbursed wages.

1.8.3 FRAUD THROUGH MANIPULATION OF ACCOUNTS

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Generally this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

1.8.4 THE AUDITOR CAN SUSPECT FRAUD UNDER THE FOLLOWING CIRCUMSTANCES.

1. When vouchers, invoices, cheques, contracts are missing etc.

2. When control account does not agree with subsidiary books.

3. When the difference in trial balance is difficult to locate.

4. When there are greater fluctuation in G.P. and N.P. ratios.

5. When there is difference between the balance and the confirmation of the balance by the parties.

6. When there is difference between the stock as per records and the stock physically counted.

7. When the explanation given by the client is not satisfactory.

8. When there is a overwriting of some figures.

9. When there is a contradiction in the explanation given by different parties.

1.8.5 PROCEDURE TO BE FOLLOWED TO DETECT ERRORS.

Following procedures may be adopted by the auditor to detect the errors.

1. Check the opening balances from the balance sheet of the last year.

2. Check the posting into respective ledger accounts

3. Check the total of the subsidiary books.

4. Verify all the castings and the carry forwards.

5. Ensure that the list of debtors and creditors tally with the ledger accounts.

6. Make sure that all accounts from the ledger are taken into accounts.

7. Verify the total of the trial balance.

8. Compare the various items from the trial balance with that of the previous year.

9. Find out the amount of difference and see whether an item of half or such amount is entered wrongly.

10. Check differences involving round figures as Rs. 1,000; Rs. 100 etc .

11. See where there is misplacement or transposition of figures that is 45 for 54; or 81 for 18 etc.

12. Ultimately careful scrutiny is the only remedy for detection of errors.

13. See that no entry of the original book has remained unposted.

1.8.6. THE AUDITOR SHOULD PERFORM THE FOLLOWING DUTIES IN RESPECT OF FRAUD.

1. Examine all aspects of the finance.
2. Vouch all the receipts from the counterfoils or carbon copies or cash memos, sales mart reports etc.
3. Check thoroughly the salary and wages register.
4. Verify the methods of valuation of stocks.
5. Check up stock register, goods inwards notes, goods out wards books and delivery challans etc
6. Calculate various ratios in order to detect fraudulent manipulation of accounts
7. Go through the details of unusual items.
8. Probe into the details of the problems when there is a suspicion.
9. Exercise reasonable skill and care while performing the duty.
10. Make surprise visit to check the accounts.

1.9 ADVANTAGES AND INHERENT LIMITATIONS OF AUDIT

1.9.1 ADVANTAGES OF AUDIT

Advantages of audit

A. Businessman's point of view	B. Investor's point of view	C. Other Advantages.
1 Detecfonof errorsandfrauds	1 . Protects interest	1. Evaluate financial status
2 Loan from banks	*2.* Moral check	*2.* Usting of shares
3 Builds reputation	3. Proper valuation of investments	3. Settlements of claims
4 Proper valuation of assets	4 Good security	4 Evidence in court
5. Government acceptance		5. Settlement of accounts
6. Update accounts		5. F aciStates calcu lation of Purchase. Conskteraton.
7 Suggestions for improvement		7 Facilitates taxation
8. Useful for agency		

1.9.2 LIMITATIONS OF AUDITING

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expresses by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. Further, the process of auditing is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of an audit procedure. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the overall objectives of an audit. The inherent limitations are:

I. First of all, auditor's work involve exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

II. The entire audit process is generally dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to records transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal controls system also contribute to inherent limitations of an audit.

Generally following are the Limitations of auditing

1. **Non-detection of errors/frauds:-** Auditor may not be able to detect certain frauds which are committed with malafide intentions.

2. **Dependence on explanation by others:-** Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.

3. Dependence on opinions of others:- Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc. he can not be an expert in all the fields

4. **Conflict with others:** - Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgement plays an important role. It differs from person to person.

5. **Effect of inflation : -** Financial statements may not disclose true picture even after audit due to inflationary trends.

6. **Corrupt practices to influence the auditors** :- The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.

7. **No assurance** :- Auditor cannot give any assurance about future profitability and prospects of the company.

8. **Inherent limitations of the financial statements :-** Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts can not be measured. Audited statements due to these limitations can not exhibit true position.

9. **Detailed checking not possible :-** Auditor cannot check each and every transaction. He may be required to do test checking.

1.10 MISCELLANEOUS

1.10.1 AUDITING Vs INVESTIGATION

Points of difference	**Auditing**	**Investigation**
1. objects	The object is to find out whether balance sheet and profit and loss account exhibit a true and fair view of business.	It is undertaken to know the essential facts about a matter under inquiry. It is done with some special purpose of view.
2 period	It usually covers one accounting year.	It may cover more than one accounting year.
3 conducted	It is conducted for proprietors only.	It is carried out on behalf of any party interested in the matter.
4 scope	It is restricted to balance sheet and profit and toss account.	It is wider in scope. It may be carried out beyond balance sheet.
5. compulsion	Audit is legally compulsory for companies.	It is voluntary. It is required under certain circumstances.
	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction.
		Form of report is not

6 time 7. report 8. appointment 9. qualifications 10. rework	Form of report is prescribed. It is presented to the shareholders. Owners appoint the auditors. The statutory auditors must posses proper qualifications. Re - audit is not generally undertaken.	prescribed. It is presented to the client. Even third party can appoint an investigator. Even an employee preferably a chartered accountant may be appointed as investigator. Re - investigation may be undertaken.

1.10.2 DISTINCTION BETWEEN ACCOUNTING AND AUDITING

Points of difference	Accounting	Auditing
1. meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. nature	It is concerned with finalisation of accounts.	It is concerned with establishment of reliability of financial statements.
3. objects	The object is to ascertain the trading results.	The object is to certify the correctness of financial statements.
4. commencement	Accounting commences when book keeping ends.	Auditing begins when accounting ends.
5. scope	It involves various financial statements. It involves maintenance of books of accounts. It does not go beyond books of accounts.	It depends upon the agreement or upon the provisions of law. It goes beyond books of accounts.

1.10.3 TRUE AND FAIR VIEW.

An audit of accounts by an independent expert assures the outside users that the accounts are proper and reliable. The outsiders can rely on the accounts if the auditor reports that the accounts are true and fair. The accounts are said to be true and fair:

1. **When the profit and loss shown in the profit and loss account is true and fair, and**

2. **Also when the value of assets and liabilities shown in the balance sheet is true and fair.** What constitutes true and fair is not defined under any law. However the following general guidelines may be laid down in connection with true and fair.

   a) **Conform to accounting principles:** The books of accounts must be kept according to the normally accepted accounting principles such as the concept of entity, continuity, periodical matching of costs and revenue, accrual and double entry system etc.

   b) **No window dressing or secret reserves:** The accounts must show the financial position and the profit or loss as they are. I.e. there is neither an overstatement nor an understatement. There should be in other words neither window dressing nor secret reserves. In window dressing the accounts are made in such a way as to show a much better condition than the actual condition. The profit and the net worth are overstated

      The accounts are said to show true and fair view when the accounts show only the actual conditions as it is. i.e. the profit and the net worth are shown as they are.

In order to show a true and fair view the auditor should ensure that:

1. The final accounts agree with the books of accounts.

2. The provision for depreciation is proper.

3. The closing stock is physically verified and valued properly.

4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.

5. Proper provision is made for bad and doubtful debts.

6. Capital expenses is not treated as revenue expenses and vice versa.

7. Capital receipts are not treated as revenue receipts.

8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.

9. Contingent liabilities are not treated as actual liabilities and vice versa.

10. Provision is made for all known losses and liabilities

11. A reserve is not shown as a provision and vice versa

12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.

13. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income are recorded properly.

14. Expected or anticipated gains are not credited to the profit and loss account.

15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly

16. The exceptional or non-recurring transactions are disclosed separately in the accounts.

3. Disclose all material facts: The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities. Material means important and essential. The disclosure of important matters in the accounts helps the users in taking business decisions. There should be neither suppression of vital facts nor mis-statements.

4. Legal requirements: In case of limited company the account must disclose the matters required to be disclosed under the Companies Act. The final accounts must be in the format prescribed under Schedule VI of the Companies Act, 1956. Special companies such as banks, insurance, electricity supply companies prepare accounts as prescribed under special laws. A co-operative society, a trust etc. must also prepare the accounts as required under relevant laws.

5. Requirements of Institute of Chartered Accountants of India: The accounts must also be in accordance with the various guidelines prescribed by the ICAI. These guidelines are contained in the statements, standard and guidance notes issued by the institute from time to time.

1.10.4 ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Apart from this abvious utility, there are other advantage of audit. Some or all of these are of considerable value even to those enterprises and organization where audit is not compulsory, these advantages are given below:

(a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(b) It acts as a moral check on the employees from committing defalcations or embezzlement.

(c) Audited statements of account are helpful in setting liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(d) This are also use for settling trade disputes or higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastage and losses to show the different ways by which these might be checked, especially those that occur due to the absence of inadequacy of internal checks or internal control measures.

(f) Audit ascertains whether the necessary books of accounts and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respects.

(g) As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weakness, inadequacy, etc., in them.

(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(i) Government may require audited and certificated statement before it gives assistance or issues a licence for a particular trade.

1.10.5 QUALITIES OF AN AUDITOR

So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important.

Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. AAS-8 on 'Audit Planning' emphasises that an auditor should have adequate knowledge of the client's business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

1.13 LET US SUM UP

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation. Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into a) primary objective and b) secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds.

A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit.

Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

1.14 KEYWORDS

Auditing: Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

Continuous audit: An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

Errors: Mistakes committed innocently and unknowingly while making entries in the books of accounts.

Frauds: Fictitious entries made in the books of accounts with certain motives.

Interim audit: An audit which is conducted for a part of the accounting period for some specific purpose.

Investigation: Examination of accounts for special purpose.

Qualified auditor: A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act,1949.

Statutory audit: An audit undertaken under any specific statute or Act.

True and fair view: A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain **errors** and fraud.

1.15 BIBLIOGRAPHY

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1.16 QUESTIONS

1. Check your progress

i) Define auditing.

ii) Distinguish between accountancy and auditing.

iii) State whether the following statements are true or false.

a) Auditing of accounts is compulsory in a partnership firm.

b) Auditing of accounts is undertaken to detect fraud in the books of accounts.

c) A professional auditor cannot take up the work of preparing the accounts of a company.

d) Investigation is taken up only on behalf of the owner of the entity.

e) Investigation of accounts is not compulsory but audited by the qualified professional accountant.

f) In ancient period the audit was confined to cash audit and not to locate fraud.

g) Audit of company accounts is compulsory under the Chartered Accountants Act, 1949.

2. Check your progress

1. List the types of clerical errors.

2. Distinguish between errors and fraud.

3. What do you mean by window dressing.

4. Fill in the blanks with the appropriate word given in the bracket:

   a) when two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as ______(error of omission/compensating error)

   b) ——————are always committed deliberately and intentionally to defraud the proprietors of the organisation (error/fraud)

   c) the main objective of ——————is to avoid or reduce the tax liability.(window dressing/secret reserves)

   d) to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is—————of an audit .(primary objective/secondary objective)

5 State whether the following statements are true or false.

   a) The main object of auditing is to detect frauds from the books of accounts.

   b) The allocation of amount between capital and revenue expenditure is a compensating error.

c) Audited accounts are free from errors and fraud.

d) The main purpose of auditing is to report on the efectiveness of the internal check system of organisation.

e) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.

f) The auditor is appointed to report on the financial position of the company carrying out an analytical examination of the books of accounts related documents and internal and external evidences.

g) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.

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