INTRODUCTION TO AUDITING

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

DEFINITION:

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."

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.

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.

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.

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 ofPurchase. Conskteraton.
7 Suggestions for improvement		7 Facilitates taxation
8. Useful for agency		

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.

BASIC PRINCIPLES OF AUDIT

AAS-1 describes the basic principles, which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. These are:-

1. Integrity, objectivity and independence:
The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever it's actual effect, as being incompatible with integrity and objectivity.

2. 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 legal

or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.

3. Skill and competence:

The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others:

When the auditor delegates work to assistant* or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise & review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.

5. Documentation:

The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning:

The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.

7. Audit evidence:

The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.

8. Accounting system & internal control:

The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

9. 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.

The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.

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.
	Audit is legally compulsory for companies.	It is voluntary. It is required under certain circumstances.

5. compulsion	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction.

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.

AUDIT TYPES

INTERIM AUDIT:

An audit that is taken up between two annual audits is called an Interim Audit. A specific date, as per the client's requirement is taken into account, e.g. 30th September, 31st

December, etc. a trial balance is drawn and verified with a view to prepare financial statement. Financial statement are prepared and authenticated for the interim audit period. Assets and liabilities are verified for interim

balance sheet purposes. Independence is considered less independent than the statutory Auditor; generally an employee of the enterprise will be the internal auditor. In the interim audit no format is prescribed. It depends on the nature of work, coverage and audit observations.

CONTINUOUS AUDIT:

A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period.

A continuous audit is preferred for the following reasons:

i. It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors of frauds uncovered by such an audit.
ii. The frequent attendance by the staff deters persons so inclined, from committing a fraud.
iii. The accounting staff of the client is motivated to keep the books of account up-to-day.

MEANING OF AUDIT PROGRAMME

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

1. stay within the scope and limitation of the assignment.
2. determining the evidence reasonable available and identify the best evidence for deriving the necessary satisfaction.
3. Apply only these steps and procedures which are useful in accomplishing the verification purpose In the specific situation.
4. consider all possibilities of error.
5. co-ordinate the procedures to be applied to related items.

QUALIFICATION OF AN AUDITOR

The provision regarding qualification of auditor is governed by Section 226 of the Companies Act, 1956 Sec 226(1) states

- A person will be qualified for appointment as an auditor of a company (public or private) only if he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949

- The same section also provides that a firm of Chartered Accountants will be qualified for appointment as the auditor of a company in its firm name provided all the partners practicing in India are qualified for appointment

- In case of the firm being appointed as auditor, any practicing partner may act in the name of the firm.

DISQUALIFICATION OF AUDITORS

The provision regarding disqualification of auditor is governed by section 226 of the Companies Act, 1956.

1. Section 226(3)

The following persons are not qualified for appointment as auditors of a company:

a) A body corporate an officer or employee of the company

b) A partner or employee of an officer or employee of the company
c) A partner or employee of an officer or employee of the company
d) A person who is indebted to the company for more than Rs. 1000 OR A person who has given any guarantee or provided any security in connection with the Indebtedness of any third person to the company for more than Rs. 1000.
e) A person holding any security (a security would mean an instrument carrying voting rights) of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

2. Section 226(4)

A person is not eligible for appointment as an auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company and vice- versa.

3. Section 226(5)

If an auditor after his appointment, becomes subject to any of the disqualification mentioned in section 226(3) and section 226(4), he shall be deemed to have automatically vacated his office.

APPOINTMENT OF FIRST AUDITORS

The main points regarding appointment of the First Auditors of a company are given in **Section 224(5)**:

1. The first auditors of a company can be appointed by the board of directors within one month of the date of registration/ incorporation of the company by means of a resolution.
2. The auditors so appointed shall hold office until the conclusion of the first Annual General Meeting.
3. If the Board of Directors fails to appoint the First Auditor within one month, the company in a general meeting is empowered to make the appointment.
4. The auditors so appointed by the Board of Directors may be removed by the company at a general meeting which may appoint any other auditor.
5. An auditor cannot be appointed as First Auditor simply because his name has been stated in the Articles of Association.
6. The First Auditor need not sent an intimation by the company of their appointment and the First Auditor are themselves not required to inform the registrar of Companies about their acceptance/ refusal of such an appointment.

REMOVAL OF AUDITOR

The first auditor appointed by the directors may be removed by the shareholder in the first Annual General Meeting. Such Auditors can even be removed from their office before the expiry of their term of office without the permission from the Central Government.

1. In any other case, auditor can be removed only by the company in General Meeting after obtaining previous approval from the Central Government

2. An Auditor, on the expiry of the terms of his office may not be reappointed and thus removed from his office.
   a) Resolution requiring special notice (of fourteen days) should be passed at the general meeting [Sec. 225(1)].
   b) On receipt of notice of resolution, company shall send copy of the notice to the retiring auditor [Sec. 225(2)].
   c) On receipt of notice, retiring auditor can send written

representation of a reasonable nature to the company which should be informed to the members. Normally company has to circulate such representation to the shareholders, unless it is received too late. A notice of resolution also should be circulated, stating a fact of such a representation. If the representation in not circulated for being received too late or because of the default of the company, auditor can insist it to be read at the meeting. [Sec. 225(3)].

d) However, company or any other person like directors or shareholders have a right to file a petition with Company Law Board (CLB) to refrain the
e) Auditor from making such representation, if it is to secure needless publicity or is defamatory. In such a case, on the direction of the CLB, copies need not be sent or read at the meeting [Sec. 225(3)]. These provisions apply to removal of the auditors appointed by Central Government also.

3. The other relevant provisions are that if a new auditor is appointed, the company should within 7 days, inform the new auditor. The new auditor should inform the Registrar within one month of such intimation received about his decision and he should also communication with the retiring auditor in this matter, is he accepts the post