# Diploma in Financial Management & Accountability

*- A joint initiative of TISS & FMSF*

## Course Material

## Audit

## Paper - VII

## Module - IV

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# UNIT- 1
# NATURE OF AUDITING

## 1.1. INTRODUCTION

No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different points of time with numerous persons and entities. The effects of all transactions have to be recorded and suitably analyzed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organization or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management. For example, shareholders in a company certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic and also certifies for the reliability of the information contained in the financial report and creates confidence in the minds of various stakeholders on the results of information contained in the financial statements.

When the business size is very small and owned by persons who are maintaining the accounts and no other stakeholder is involved, the need for audit is not felt necessary. But with the increase in the geographical locations, management requiring delegation of authority and responsibility, separation of ownership from the management and involvement of various stakeholders, like bankers, etc. initiated the need for audit of the financial statement.

In the case of company, where the ownership is in the hands of the shareholders and management is in the hands of the Board, it is in the interest of the shareholders to have an audit of the financial transactions done to ascertain the reliability of the financial statements and the result shared with them.

The need for audit is also recognized by various statutory bodies, which makes the audit compulsory. In these context different acts like Companies Act, Income Tax Act provides the compulsory audit in order to safeguard the interest of the relevant shareholders.

In the case of an NGO, the audit is more relevant and necessary .In the case of company, the shareholders who have ownership stake and are the beneficiaries of the companies' profits, have the authority to appoint management team of their choice and also have the authority to appoint Auditors to examine and report the correct and authentic financial results of the enterprise.

However in the case of NGO the main stakeholder is the beneficiaries, for whom all the funds are received, but they are neither involved in the management decision making nor have any say in the governance system of the organization. The same is the case of other major stakeholders i.e. donors as they also do not have any control over the decision making over the NGO. The audit is therefore one of the most important tool in the hands of donors, Government and other stakeholders to ascertain that the funds received by the NGO are utilized for the purpose for which these are being received.

## 1.2. DEFINITION OF AUDITING

The word "audit" is derived from the Latin word "audire", which means "to hear". In olden times, some impartial and experienced persons were appointed to check the accounts of the parties responsible for financial transactions and express their opinion about their correctness or otherwise. Such persons were known as "auditors". Thus the term "auditor" literally means "one who hears" and it is used ever since the days when public accounts were accepted and approved on the basis of hearing the accounts read.

It is not an easy task of giving a precise definition of the word "audit" in a word or two. Originally its meaning was confined merely to a cash audit, i.e., an auditor has to ascertain whether the person responsible for the maintenance of accounts had properly accounted for all the cash receipts and payments on behalf of his principal. But the scope of audit to-day has much widened. It now means a thorough scrutiny of the books of account and its ultimate aim is to verify whether the Balance Sheet and the Profit and Loss Account or Revenue Account exhibit a true and fair view of the financial state of affairs of a concern.

Following are some of the formal and recognized definitions of the word "auditing"

As per Terminology for Accountants, auditing has been defined as under :

"In connection with the financial statement, an audit is an examination of accounting records and other supporting evidence of an organization for the purpose of expressing an opinion as to whether financial statements of the organization present fairly its position as at a given date and results of its operations for the period ended on that date in accordance with the generally accepted accounting principles".

The International Auditing Practices Committee (IAPC) of the international Federation of Accountant (IFAC) has defined the term 'Audit' as:

" The objective of an audit of financial statement is to enable the auditor to express an opinion whether the financial statements are prepared in all material respects, in accordance with an identified financial reporting framework or other criteria".

According to AAS-1 on "Basic Principles Governing an Audit", "An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon". The person conducting this process should perform his work with knowledge of the use of the accounting statements discussed above and should take particular care to ensure that nothing contained in the statements will ordinarily mislead anybody. This he can do honestly by satisfying himself that :

(i) the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by underlying papers and documents and by other evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts taken as an integrated whole, present a true and fair picture of the operational results and of the assets and liabilities.

The aforesaid definition is very authoritative. It makes clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity. The definition given in AAS-1 is restrictive since it covers financial information aspect only. However, the scope of auditing is not restricted to financial information only, but today, it extends to variety of non-financial areas as well. That is how various expressions like marketing audit, personnel audit, efficiency audit, production audit, etc. have came into existence.

## 1.3. OBJECTIVE OF AUDITING

The objective of an audit can be divided into two parts; namely:

- Primary objectives and

- Secondary objectives

### 1.3.1. Primary objectives

The primary objective of an audit is to enable the auditor to express his opinion (report) on the:

- Truth and fairness of the financial position shown by the balance sheet
- Adequacy of the information required to be disclosed in the financial statements.
- Compliance with statutory requirements; and
- Accuracy and reliability of books of accounts and underlying records from which the financial statements have been prepared.

The auditor is required to state clearly in his report whether or not, in his opinion, the accounts show a true and fair view. In the event he is unable to express his opinion affirmately on the truth and fairness of accounts, he must qualify his report or disclaim responsibility stating the reasons and extent to which he considers the accounts to be deficient which prevented him to report in affirmative terms.

The primary objective of an audit therefore is to provide a report by the auditor stating therein his opinion on the truth and fairness of financial statements so that the person using such statements can have a critical appreciation of the information contents of the statement in them. The audit therefore provides an opportunity to users of the financial statements to understand the information contained in therein in realistic manner. An audit, in fact, adds transparency to financial statements and shows them in proper light.

In the case of statutory audits under the Companies Act, 1956or any other applicable statute, the audit report should state whether or not in the opinion of the auditor proper books of accounts have been maintained and whether the financial statements prepared therefrom are in agreement with the related accounting records.

In case of non-statutory audits, the scope of the audit is determined by the terms of reference the auditor receives from the person /authority appointing him. Assuming that no restrictions have been placed on the scope of his work by the person /authority, he should express his independent opinion on the truth and fairness of accounts.

### 1.3.2. Secondary objectives

Detection and prevention of frauds and errors are considered secondary objectives of audit. Though the broad objectives underlying audit i.e. to check the fidelity of the persons rendering the accounts, continues even today but the emphasis on auditor's responsibility has shifted from detection and prevention of errors and frauds to expression of opinion on truth and fairness of financial statement except that in the event the auditor during the course of his verification process discovers a fraud and/or error, he is required to go deeply in the matter and report his views. While conducting the audit, therefore the auditor should keep in mind the possibility of existence of the fraud or irregularity in accounts, particularly when he discovers that the internal controls are weak. The function of the auditor therefore, has come to be regarded as an attester of the financial statements and reporter of his opinion thereon.

## 1.4. PRINCIPAL ASPECTS TO BE COVERED IN AUDIT

The principal aspect to be covered in an audit concerning final statements of account, which can also be called functions of audit, can be summarized as follows:

a) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

b) Reviewing the system and procedure to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow fraud and errors going unnoticed.

c) Checking of the arithmetical accuracy of the books of accounts by the verification of postings, balances, etc.

d) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

e) Ascertain that a proper distinction has been made between items of capital and of revenue nature and that the amount of various items of income and expenditure adjusted in the accounts correspond to the accounting period.

f) Comparison of the Balance Sheet and Profit and Loss Account or other statements with the underlying record in order to see that they are in accordance therewith.

g) Verification of the title, existence and value of assets appearing in the Balance Sheet.

h) Verification of the liabilities stated in the Balance Sheet.

i) Checking the result shown by the Profit and Loss and to see whether the results shown are true and fair.

j) Where audit is of a corporate body, conforming that statutory requirements have been complied with.

k) Reporting to the appropriate person/body whether the statements of accounts examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

## 1.5. 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. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.

These principles are being discussed in brief :

- **Integrity, Objectivity and Independence** - The auditor should carry out his professional work with honesty and sincerity. He should be fair and impartial and also do his work without any prejudice. He should do his work without any fear or favor. He should not jeopardize his independence for any consideration.

- **Confidentiality -** The auditor should not disclose any information about his client to any third party unless he has a legal or professional obligation to disclose such information to the third party.

- **Skill and Competence** - The audit should be performed with due care and skill by those persons who have got training, experience and competence to carry out audit.

- **Work done by others** - The auditor is responsible for all the work including that done by other auditors on his behalf and/or jointly with him. However; he is entitled to rely on other auditors work, provided he exercises due care and skill and is not aware of any reason for non-reliance on the other auditor. In the case of statutory appointments of auditors, such as appointment by a company having branch(es), the auditors report should expressly state whether the auditor has received reports on branch accounts audited by other auditors and how he has dealt with the same. He should also carefully guide and supervise the work done by his staff. He should satisfy himself that the work done by other auditors or experts is adequate and satisfactory for his purpose.

- **Documentation -** The auditor should build-up necessary documents to record that the audit was done according to basic principles of auditing.

- **Planning** - The auditor should plan his work properly to carry out the audit in an efficient manner and to complete it within reasonable time. He should be familiar with the organization's activities and its policies and procedures. The plans should be revised, if necessity arises.

- **Accounting System and Internal Control** - The auditor should gain an understanding about the client's accounting system and internal control with a view to determining the extent of checking necessary, the nature of audit tests to be applied and audit procedures which he should follow in carrying out the audit.

  In particular, he should see that the accounting system and the internal control distinctly relate to the flow of jobs physically performed in the organization.

- **Audit Conclusions and Reporting** - The auditor should review and assess the audit conclusions drawn from the audit evidence and from his knowledge to ensure that the financial statements have been prepared in accordance with the manner laid down, if any, in any law and generally accepted accounting principles and are in agreement with the relevant books of account and disclose all relevant information.

  The audit report should contain auditor's opinion in clear terms i.e., without any ambiguity about the financial position and results of operations. If the report contains any qualification, it should be quantified in financial terms wherever possible and should be substantiated by the reasons for the qualification.

## 1.6. SCOPE OF AUDIT

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. The form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable.

Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

## 1.7. CLASSIFICATION OF AUDIT

The audit may be classified

### (a) On the basis of legislative control

The audit can be broadly classified into two categories:

- Statutory and
- Non-Statutory (Voluntary or private) audits.

- **<u>Statutory Audit:</u>** Audit of an organization performed under the statute is called Statutory audit. In the case of Statutory audit, the scope, duties and responsibilities of auditors are laid down by the relevant statute which cannot be modified or curtailed by the client. Companies, Public and Charitable Trusts, Societies are some of the organizations that require the audit to be conducted under law and as such these audits are called statutory audit.

This includes audit under Income Tax Act, Foreign Contribution Regulation Act, etc.

- **Non-Statutory Audit**

  Non-Statutory audits are performed by auditors because the members or the governing bodies of organizations desire them to be audited not because the law required but because it provides them an assurance of reliable accounts and financial state of affairs. Sometimes the external resource sharing agencies also want the audit of their relevant fund and these audits are also under the ambit of Non-Statutory audit.

**(b) On the basis of relation of auditor vis-à-vis management:**

- **Internal Audit and External Audit**

  The audit is said to be external if the appointment of auditor is made by persons other than those whose performance is evaluated by auditor. For example, the directors of the company are responsible for the activities of the company. They present an account of company's performance to the shareholders through P&L account and Balance Sheet. The statutory auditor is said to be external auditor because he is appointed not by the management but by the shareholders. The external auditor is an independent person. The scope of his audit cannot be curtailed by the management. The external auditor submits his report to the appointing authority, say, shareholders in case of joint stock companies. Generally, the external auditor verifies the truth and fairness of financial information as reflected in financial statements of the entity.

  On the other hand, an audit is said to be internal when the auditor is appointed by person who are responsible for the performance of the entity. An internal auditor is usually appointed by management of the company. In many cases the internal auditor is in regular employment of the entity. In few cases, external audit firms are engaged to conduct internal audit. However, their terms of appointment, remuneration and scope of audit work etc. are determined by the management. The internal auditor is not completely independent. The scope of his work can be controlled by the management. The internal auditor submits his audit report to the chief of management team. The internal auditor generally extends his review to non-financial areas as well. Besides verifying financial data generated in accounting system of the entity, the internal auditor evaluates the existing systems, operations and policies to suggest improvement in respect of them. The internal audit report is more in the nature of the management information report. The management is at liberty to take appropriate action on internal audit report.

**(c) On the basis of periodicity of audit :**

**Interim, Final and Continuous Audit**

- **Interim Audit** - Timing aspect of the performance of audit function leads us to another form of classification of audit i.e., - interim audit, final audit and continuous audit. Interim audits are carried out during the year covering accounting records for a certain period of the year, say, a quarter or half-year, and finally the auditors come again at the year end to finalise the yearly audit. Such audits are done for large clients where performing detailed audit work may not be possible at the year end due to large number of transactions, possible non-availability of adequate staff and time constraint. Accordingly, a progressive but cumulative audit in terms of time segment is own as interim audit which culminates into year-end audit.

- **Final Audit -** The final audit is done after the organization's financial year is over. It may commence immediately after the close of the year or after lapse of some period. The organization's submits complete accounts of the year in draft form and these are then examined by the auditors. There is an element of relationship between system based audit and balance sheet audit on the one hand and Interim and final audits, on the other. Most of the audit work pertaining to systems approach is carried out during interim audits, but in the case of balance sheet audit, majority of work is done during final audit.

- **Continuous Audit** - In some large organizations, it becomes imperative to carry out the work continuously. In the case of continuous audits, the audit staff either makes several visits to the client throughout the year or in some cases staff remains present at the clients place virtually throughout the year. Continuous audits are carried out mostly in very big organizations where the bulk and variety of transactions are significant, Now-a-days with greater acceptance of internal audit (which in any case is continuous), continuous audit is not much in practice. Detailed audit work is generally carried out continuously and only that work which cannot be completed during the year is left to be done at the year end. Such work involves adjustment entries, determination of the status of legal claims, preparation of depreciation schedules, presentation of accounting information and disclosures etc.

## 1.8. LIMITATIONS OF AUDITING

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 auditors' opinion which helps determination of the true and fair view of the financial position and operating results of an NGO. However the audit suffers from certain limitations. Some of them are discussed below :

a) It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise.

b) 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 audit procedures. The inherent limitations are :

   i) First of all, auditor's work involves 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.

   ii) 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.

   iii) 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.

c) The present requirements are very complex in nature and the auditor has to be very efficient and qualified to act within the present situation. But it is extremely difficult to obtain an auditor who will be expert, efficient, properly qualified and have profound knowledge about the different types of problems.

d) The audit cost is also an important factor. Unless the audit can be accomplished at a reasonable cost, the users may find it uneconomical and perhaps not worth the price. This consideration, however, is not applicable to statutory audits to its full extent.

## 1.9. DIFFERENCE BETWEEN AUDIT AND ACCOUNTING

Accounting is concerned with the recording, classifying and summarizing of the transactions and preparing of accounts. Auditing is concerned with detailed and critical examination of accounts prepared by others.

Frequently, the auditor of a company also is called upon to prepare the accounting statements (i.e. profit and loss account and Balance Sheet). While he prepares them, he is acting as an accountant. When he subjects such statements to critical examination, he acts as an auditor. Thus, we can say, auditing begins where accounting ends.

## 1.10. DIFFERENCE BETWEEN AUDIT AND INVESTIGATION

The difference between audit and investigation can be analysed as follows :

| Sr. No. | Points of Distinction | Audit | Investigation |
|---|---|---|---|
| 1. | Main Purpose | The main purpose of auditing is to see whether the financial statements show true and fair view of state of affairs and profitability of the company. | Investigation is critical examination of the accounts with a special purpose. It may be in connection with a suspected fraud or for finding out the proper utilization of the grant money received. |
| 2. | Period Covered | Audit is concerned with the examination of books of accounts and records for the period concerned which is usually one year | An investigation may cover even two years or more. |
| 3. | Books Examined | Audit is the examination of the books of accounts and other records connected there with. | The scope of Investigation many a time requires examination of other records also. |

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|---|---|---|---|
| 4. | Qualification | Auditing is carried out by the persons qualified under the Companies Act, 1956. They are, thus outside the organisation. | Investigation may be carried out by persons in the employment of the company or may be by the outside agencies. |
| 5. | Appointment | Auditors are generally appointed by shareholders of the company. | Many a times, third parties appoint investigators to conduct a particular investigation. |
| 6. | Extent of Checking | Depends on degree of reliance on internal control. | Detailed, exhaustive and thorough checking. |
| 7. | Aspects covered | Only financial aspects are covered | Financial and non-financial aspects are covered. |
| 8. | Preconceptions | Audit is not based on suspicion unless circumstances require. | Investigation is based on pre-conceived notion suited to objective. |

### 1.11. DISTINCTION BETWEEN REPORTS AND CERTIFICATES

A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion.

When an auditor certified a statement, it implies that the contents of that statement s are measurable and that he has verified the accuracy of the data. The term “certificate” is, therefore, used where the auditor verified the accuracy of facts. An auditor may, thus, certify the circulation figures of a newspaper or the value of import or exports of a company An auditor’s certificate represents that he has verified certain figures and is in a position to vouchsafe their accuracy as per his examination of documents and books of account.

A report, on the other hand, is a formal statement usually made after an enquiry, examination or reviews of specified matters under report and includes the reporting auditor’s opinion thereon. When we say that an auditor is reporting, we imply that he is expressing an opinion. The term “report” in the context of an independent audit of financial statements implies that the auditor has examined the relevant records in accordance with generally accepted auditing practices and is expressing an opinion on whether or not the financial statements reflect a true and fair view of the state of affairs and the working results of the enterprise. An auditor cannot guarantee that the figures in the balance sheet and income and expenditure account are absolutely precise; he cannot certify them. This is primarily because he can take only an overall view of the accounts through normal audit procedures. Similarly, in the case of an internal audit, an auditor may express his opinion on a given proposition, e.g. whether a particular division has operated efficiently or not.

## 1.12. SELF ASSESSMENT QUESTIONS

**i) What is auditing?**

**ii) State which of the following statements are true :**

**a) There is little difference between auditing and accounting as both deals with financial statements.**

**b) An auditor is expected to point out to the management, flaws and loopholes in the system of accounting.**

**c) The auditor compares entries in the books of account with the vouchers; and, if the two agree, his work is done.**

**d) Safeguarding the company's property is the function of management; hence the auditor is not concerned with verification of assets and liabilities.**

**iii) What are the differences between Accounting and Audit?**

**iv) What are the differences between auditing and investigation?**

**v) Differentiate the following :**

**a) Statutory & non-statutory audit**

**b) Internal & External Audit**

**c) Continuous Audit and Periodical Audit.**

**vi) Discuss the scope of the audit.**

**vii) Discuss the basic principles of audit.**

**viii) What are the objectives of auditing?**

**ix) How the audit can be classified on the basis of legislative control and on the basis of relationship of the auditors with the management?**

**X) What is the difference between Report and Certificate?**