Introduction of Auditing
Chapter: One

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

Definition of Auditing

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.

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.

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.

OBJECTIVES OF AUDITING

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 objectives of auditing are:
i. Detection and prevention of Frauds:

ii. Detection and prevention of Errors.

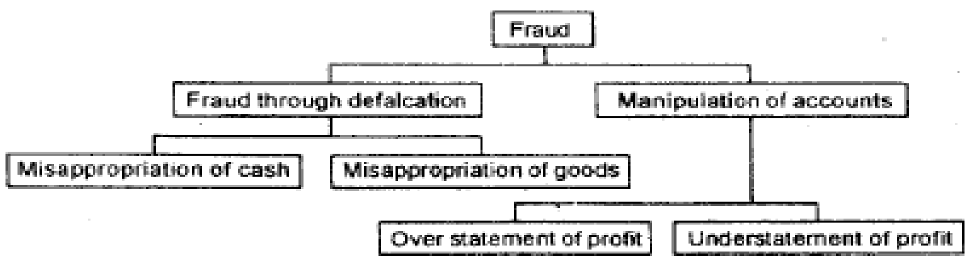
DETECTION OF FRAUD & ERRORS

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



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.

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.

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 fluctuations 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.

ADVANTAGES OF AUDIT

A. Businessman's point of view	**B. Investor's point of view**
1. Detection of errors and frauds	Protects interest
2. Loan from banks	Moral check
3. Builds reputation	Proper valuation of investments
4. Proper valuation of assets	Good security
5. Government acceptance	
6. Update accounts	
7. Suggestions for improvement	

AUDIT TYPES;

A. On the basis of Legislation:

1. **Statutory audit**
2. **Government audit**
3. **Private Audit**

B. On the basis of Periodicity:

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.

TYPES OF AUDIT

CHART SHOWING DIFFERENT CLASSES OF AUDIT

A. Based on Organisational Structure **B. Based on Scope** **C. Based on time** **D. Based on object** **E. Other Types**

Statutory Balance Sheet Audit
Audit
Non-statutory Audit
Govt. Audit

Private Audit

Sole Proprietorship
Partnership Firm
Non-profit Organisation

Continous Audit
Final Audit
Interim Audit

Complete Audit
Partial Audit
Detailed Audit
Independent Financial Audit

Cost Audit
Management Audit
Internal Audit
Social Audit

Operational Audit
Tax Audit
Special Audit
Environmental Audit
Occasional Audit
Propriety Audit
Secretarial Audit
Audit in Depth
Cash Audit

Terminologies:

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.

1.10.2 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.