Unit V

Auditing

1.1 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

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 profiVloss 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."

1.2 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.

1.3 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 Alc 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 Le. principle errors, or error arising out of negligence of accounting staff Le. Clerical errors.

1.4 Accounting and Auditing

Accounting	Auditing
1. Nature	
Accounting refers to preparation of of Accounts	Auditing refers to examination and checking of financial record.
2. Objective	
The primary object of Accounting is to find out the trading result of business during a financial year and show the financial year and show the financial position of the concern on a particular data.	The primary object of auding is to certify the correctness and justification of the financial statements prepared by the accountants.
3. Qualification	
The accountant need not be a chartered Accountantant.	The aduditor must be a chartered Accountant.

4. Appointment	
The accounting work is done by an employee of the concern and works directly under the control of management	The auditor is not an employee. He is an independent person professionally competent appointed by the preprietor with specefic purpose.
5. Status	
The accounting work is done by a permanent employee of the concene	The audit work is done by a outsider.
6. Scope	
Its scope is restricted to preparation of financial statements and either interpretation.	It is determined by the agrement between auditor and his client.
7. Commencement	
Accounting starts where book-keeping ends.	It starts where Accountancy ends.
8. Knowledge	
The accountant may or may not have knowledge of Auditing and its techniques.	The auditor must have thorough knowledge of Accountancy.

1.5 Auding and Investigation

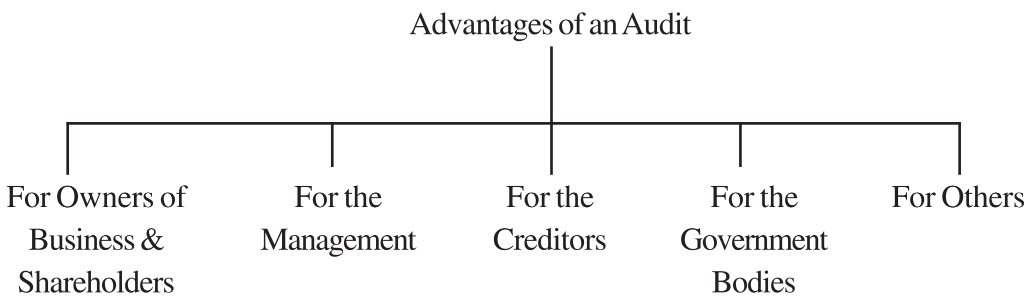
Auditing	**Investigation**
1. Purpose	
Auditing is conducted to ascertion whether the Balance sheet exhibits the true and fair view of the concern	Investigation is conducted with some special purpose. For Ex- To know the earning of the business, to know the actual financial position of the company etc.
2. Nature	
It is entermine in nature	It is intensine in nature.
3. Scope	
It immplies the examination of the accountants of a business.	It involves not only the critical examination of the accounts but also an exhaustine and close enquiry into other matter relevant to the purpose of investingation.
4. Qualification	

	Auding should he conducted only by a practising C.A.	Investigation may be conducted by any persson the need not be a C.A.
5.	Compulsion	
	Audit is compulsory in case of joint stock companies.	Investigation not legally compulsory.
6.	Time period	
	It is a kind of test checking.	It is a thorough examination of the vaccounts of business
7.	Adjustment	
	No Adjustments are done in the case of Audit since annual accounts are prepared	Certain Adjustments have to the made to ascertain the net or actual earning capacity of the business.
8.	Evidence	
	In case of auding the auditor is concerned only with primafacie evidence	In case of investingation, the investigator is concerned with substances evidence and sometimes conclusine evidence are also seen.

1.6 ADVANTAGES OF AN AUDIT

Importance of auditing can be judged from the fact that even those organisations which are not covered by Companies Act, 1956 get their financial statements audited. It has become a necessity for every commercial and even non-commercial orgaisation. People are interested to know the true facts about their business which are helpful to them for future planning and improvements in operations.

Sold trader is interested in knowing whether the business is conducted efficiently or not. To maintain healthy relations among the partners, in case of partnership business, it is important that true financial statement must be made known to every partner. Because of separation of ownership and management in joint stock companies, shareholders do not have knowledge of day-to-day administration. Shareholders would like to know whether the amount invested by theme is properly used or not. Answer for all such questions can be obtained by getting the accounts audited from a qualified auditor.



1. **For the Businessmen and Shareholders :'**

(i) In case of sole trader, he can depend on the audited accounts. He can value his business on the basis of audited accounts for the purpose of sale of business or for admitting a new partner.

(ii) Dispute over the correctness of profits can be avoided. In case of partnership firm, audited accounts will be useful in valuing goodwill and business on admission and retirement of a partner.

(iii) Shareholders, who do not know about day-to-day administration of the company, can judge the performance of management from audited accounts.

(iv) Shareholders can value their shares on the basis of audited financial statements.

2. **For the Management**

(v) It helps the management is detecting and preventing errors and frauds.

(vi) It keeps the accountants and staff vigilant while preparing books and records as they know in advance that all the accounts are to be audited.

(vii) Claims due to fire, theft and accident can be estimated from audited accounts.

(viii) Management gets advice on financial affair from the auditors who have expert's knowledge.

(ix) Because the audited accounts are uniformly prepared over the year, comparison of such statement becomes easier.

3. **For the Creditors**

(x) Long-term and short-term creditors can depend on audited financial statements while taking decision to grant credit to business houses.

4. **For the Government Bodies**

(xi) Taxation authorities depend on audited statements in assessing the income-tax, sales-tax and wealth-tax liability of the business.

(xii) Audited accounts can be produced in the Court to provide an evidence.

.(xiii) Audited accounts are useful for the government while granting subsidies etc.

5. **For Others**

(xvi) It can be used by insurance companies to settle the claims arising on account of loss by fire.

(xvii) In case of amalgamation and absorption, the purchasing company can calculate purchase consideration on the basis of audited accounts.

(xviii) It safeguards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

Limitations of Audit

The audit of accounts suffers from several limitations also. Some of the limitations are as follows:

2. Types of Audit and Conduct of Audit and methods

2.1 Classification on the Basis of the The time

1. Continuous Audit :- A continuous audit or a detailed audit is an audit which involves a detailed examination of the books of accounts at regular intervals of say 1 month or 3 months. The auditor visits his clients at regular or irregular intervals of time during the financial year and checks each and every transaction. At the end of the year, he checks the profit and loss account and the balance sheet.

2. **Periodical or Final or Complete Audit**

   Periodical audit is one which is taken up at the close of the financial period. When all the accounts have been balanced and final accounts have already have prepared. It may also commence before the final accounts are prepared and continue till the audit is completed even after the close of finanical period.

3. **Interim Audit**

   Interim audit is an audit, which is conducted in hetun two annual audits with a view to find out interim profit of the business to enable it to declare aw interim dividend. It is a kind of Audit which is conducted between the two periodical or balance sheet Audit.

4. **Partial audit**

   It is a kind of audit where the work of the auditor is curtailed. The auditor is asked to check a few books. For ex- he may he asked to check the payment side of the cash book partial audit is not permitted by case of minited companies.

5. **Occasional audit**

   As the name indicates this type of audit is conducted once a while whenener the need arises and the client desires it to the carried out. This is possible only in the case of proprietosy concerns.

6. **Standard audit**

   Standard audit can be defined as a 'complete check and analysis of certain items and contingents upon effective internal check, appropriate test checks on remaining items, the whole of work living in accordance with general auditiong standars'.

7. **Balance sheet Audit**

   Balance sheet audit means limited. Audit in which all the balance sheet accounts are verified and tests imposed only and those profit and loss items which are directly related to the assets and liabilities such as repairs and maintenance, peonision for depreciation, bad debts etc. Accounts such as these are analysed, but otherwise no detailed audit is conducted.

8. **Classification and the basis of audit dimension**

Management Audit :- Management Audit is a forward. looking, independent and systomatic evaluation of the actinties of the management at all levels for the improvement of organizational profiability and attainment of other objectives of the organization through improvement in the perform of the management function.

9. **Cost Audit**

Cost audit is effective means of control in the hands of the management to have an idea about the working of the costing deparment of the organization and suggest ways and means for its smooth running. It is the detailed checking as well as the verification of the correctness of the costing techniques, systems and cost accounts.

10. **Tax Audit**

Tax audit refers to an audit of incomes or expenses or specific claims of deductions or enemptions for the purpose of assessment of income tax. Tax Audit is required in addition to financial audit which does not fulfill the specific requirement of the tax authority.

11. Human resources Audit

Human resource audit of income tax. Tax Audit is required in addition to financial audit, which does not fulfill the specific requirement of the tax authority.

11. **Human resource Audit**

Human resource audit is concerned about the human asset figure that appears in the balance sheet through checking inspecting and appraising the various facts and figures, which are loosed on the estimated value of human resources.

12. **System Audit :-**

System Audit is concerned with that method of checking which is directed to ascertain whether the accounting practices are up to date and economical and whther the existing practices are required to he changed so as to do the work better, quicker and at less cost under the present conditions.

13. **Proprietory Audit**

Proprietory Audit is concerned with scrutiny of executive decisions hearing on the financial and profit and loss asect of the concern with special reference to public interest and commonly accepted and standards of conduct uproprietory Audit ensures that the public mony has not been utilised for the benefit of a particular person or section of the community.

14. **Peerformance or efficiency Audit**

The efficiency audit is based on the basic economic principles. The objects of this type of Audit are to evaluate and compare the optimum return with the amount of capital innested in the business and to ensure that innestment techniques aim at giving optimum results.

15. Environment Audit

Environment Audit is the examination of the correctness of environmental accounts of revenues and costs of environmental and natural resources their estimate, depreciation and values recorded.

16. Social Audit

Business organisations are now regarded as a great social force. Social audit aims at an assessment of the performance of an entity towards the fulfilment of social obligations. The objective of social audit is to bring to light for public knowledge how far and organization has discharged its responsibility to the society and to make an assessment of the social performance of the organization.

3.0 Qualifications of an Auditor

Qualification & Disqualification of an Auditor

3.1 Qualifications of an Auditor of a limited Company U/S 226(1) & (2)

The object of the provisions as to qualification of the auditors is to ensure that only persons of proson worth are appointed as auditors. The following persons will be completent to he appointed as auditors of a company.

1) See 226(1) of the company's Act lays down that a person shall not be qualified for appointment as an auditor of a company unless he is a charactered accountant with the meaning of the chartered Accountant Act 1949.

2) In case of firm, if all its partness are practising chartered accountants in India are qualified for appointment by its firm's name to the auditors of a company. In such a case any of partners caw act as aw auditors in the name of the firm.

3) Certified auditors (sec 226(2)) :

   Apart from the practising characterd Accountants a person holding a certificate under the festricted Auditors certificates rules 1956 is also qualified to he appointed as auditor of a company.

3.2 Disqualification

sec 226 (3) of company's Act laws down that name of the following persons cow be appointment as an auditors.

1. A body corporate
2. Aditor officer or Employee of the company.
3. A person whi is a partner, or who is in the employment under an office or employee of the company.

4. A person who is indebted to the company for an amount enceeded Rs.1000 or who has given any guarantee or provided and security in relation with the indebtedness of any third person to the company for aw amount enceeding Rs.1000.

3.3 Qualities of an Auditor

An Auditor has to perform wide variety of functions and to do so he must possess certain qualities. The qualities can he acquired through edducation and training. While for the others it depends upon his experience.

1. Auditor must possess requisite knowledge of accounting, Business law, taxation Economic Maths, statistics, financial and marketing management to solve practical problems.
2. Integrity is essential quality of an auditor. Auditor shoul he honest sincere and should have straight forward approach towords his work.
3. The auditor shoul he tactful in dealing with officers and staff of the client, with his assistants with his co-auditors and so .
4. The auditor should he objective, which means detached, fair and unbiased.
5. An auditor should he free of any such interest in the Enterprices the should he independent.
6. An auditor must have logical approach towards his work. He should have the capacity to analyse and interpret problems and facts.
7. The auditor should be able to communicate effectively both oral and writter communication.
8. Auditor should he able to canney his message concisely, precisely and clearly.

3.4 Appointment of an Auditor - Different methods

The pronsions relating to the appointment of Auditors are as follows.

1. Appointment of Trust Auditor of a company (sec 224(5))

The first auditor of a company shall be appointed by the Board of directors within monthy of the date of registration of the company. The auditor 30 appointed shall hold office untill the conclusion of the first annual general meeting in case the Board does not exercise its power in this regard, the first auditors shall he appointed by the company in its general meeting.

2. Appointing by company (sec 224-1(A))

Except in case of the first auditor, every company shall at each annual general meeting, appoint auditors to hold office from conclusion of that meeting until the conclusion of the nent annual general meeting. And shall within 7 days of appointment give intimation there of to every auditor so appointed.

Within 30 days of the receipt of intimation from the company about his appointment the auditor shall inform the registrar of companies in writing about his acceptance or refusal of such appointment.

3. **Appointment by central Court (Sec 224(3))**

   Where at an general meeting no Auditors are appointed or re-appointed, the central Government appoints a person to fill the vacancy. When a company fails to appoint an auditor at its annual general meeting then within 4 days of tis failure to appoint or reappoint an auditor this fact should he intimated to central Government.

4. **Appointment in case of casval vacancy (224(6))**

   Casual vacancy - This term is not defined in the Act. In its natural connotation. It means vacancy resulting from accidental circumstances such as death, incapacity or disqualification of the Auditor.

   Any casual vacancy in the office of the auditor may he filled by the Board of Directors. In case of resignation of an auditor during the term of his appointment, the vacancy shall only be filled by the company at the general meeting.

5. **Reappointment of Auditor (sec 224(2))**

   a) The auditor appointed by whatener authority shall be reappointed at annual general meeting unless he is not qualified for reappointment.

   b) If the auditor has given the company a notice in writing about his unwillingness to be reappointed.

   c) If a notice has been given of any resolution proposing the appointment of some other person in the peace of the returing auditor.

6. Appointment of auditors of court or certain other companies sec 619.
7. Appointment of Auditor by special resolutin (sec 224-A)

3.5 Removal of aw Auditor

1. **Removal of First Auditors**

   Auditors appointment by Board of directors prior to the first annual general meeting, may be removed by the members in general meeting. It is immaterial whether or not the auditor has competed his term of appointment. In the general meeting the company may appoint in his place any other persson nominated by any member of the company.

   Notice of such nomination must be given at least 14 days before the date of the general meeting.

2. **In other cases.**

   i) Special notec of resolution : Any share holder who wants to remove the present Auditor has to give a special notice of his intention to move a resolution to the company at least 14 days before the data of the general meeting.

ii) **Auditor to he informed :** On receipt of a notice for such resolutin, the company shall send a copy therefor to the retiring auditor.

iii) **Right to represent :** On receiving such notice the retiring auditor has a right to make a representation in writing, not exceeding a reasonable length to the company. He may request the company to notify such representation to members of the company.

iv) **Company to comply :** Where auditor makes a representation to the company then the company will the required to state in the notice of the resolution that such representation that such representation has been made and the company has to send a copy of the representation to every member of the company to whom the notice of the meeting is sent.

v) **Right to Attend meeting :** The auditor who is proposed to be removed, can attend the general meeting at which his removal is to he discussed. The auditor has right to make aw oral statement at the meeting where his removal is proposed such right is given to auditor to safeguard against his improper removal.

3.6 Remuneration, Rights pomers and duties of an auditors

Remuneration of Auditor (sec 224(8))

The remuneration of the auditor of a company is either he fixed by the company at its general meeting or can be fixed in any manner determined in a general meeting. If auditor is appointed by the Board or the central government his remuneration may he fixed by the appointing authority.

The remuneration is inclusive of all expenses alloved to him and if he is asked to do any other work above his normal work. He is entitled to get extra remuneration Remuneration paid to auditor must he disclosed in profit and loss Account.

Pomers / Rights of company Auditor

1. The vauditor has the right of access to books, vaccounts and vouchers (see 227(1)) whether kept at the head office of the company or else where.
2. The auditor has the right to obtain information and explanations (sec 227(1))
3. The Auditor has the right to receive all notices relating to any general meeting of the company (Sec 231) irrespective of the fact whether accounts are having discussed or not at such a meeting.
4. The auditor has a right to make a report to the member on the accounts examined by him (sec 227(2))
5. The auditor needs expert advice in respect of any legal or technical matter for proper discharge of his duties.
6. The auditor has right to have right of accuss at all times of to books, accounts vouchers maintananced at branch office (sec 228)
7. The auditor has right to receive remuneration for auditing accounts of the company (sec 224(8)).

8. Auditor has right to sign audit report (sec 229)
9. Auditor has right to he indemnfied.

Duties of Auditor

1. Auditor duty is to report to the members of the company (sec 227(2)) on accounts enamined by him and report on the accounts of any branch office audited, to state whether the Balance sheet & profit and loss Account are drawn by companies Act.
2. Auditor's duty is to assist inhesti gaters (sec 249 V(B))
3. It is duty of Auditor to inquire on loans and Advances have been properly secured.
4. Auditor duty is to sign Audit report (sec 229)
5. Auditor day is to certify the stabitory report (sec 165 (4))
6. Auditor has to verify P&L. Assets and liablities of company, Rate of devident preceding issue of prospectus (Sec 56).

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