NAME OF THE COURSE:

FUNDAMENTALS OF AUDITING

Name of the Chapter:

Introduction to Auditing

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Name of the Chapter: Introduction to Auditing

1.0 Chapter Learning Objectives:

On completion of this chapter, you will be able to:

• Understand the fundamental auditing concepts and procedures.
• Know the origin and development of Auditing
• Identify the objectives of Auditing
• Know the different types of errors and frauds
• Explain the advantages of Auditing
• Spot the different techniques and principles of Auditing
• Recognize the qualities of an Auditor

1.1 Keywords:

Auditing, Auditor, Companies Act, Frauds, Errors, True and Fair View, Manipulation, Audit Evidence, Audit Planning, Independence, Arithmetic Accuracy

1.2 Summary of the Chapter:

The basic function of auditing is to ascertain the authenticity of books of accounts prepared by the accountant. It is a well-known saying that "where the function of Accountant ends, the audit begins to determine the true and fair picture of such accounts." Traditionally, audits were mainly associated with gaining information about financial systems and the financial records of a company or a business. However, recently auditing has begun to include non-financial subject areas, such as safety, security, information systems performance, and environmental concerns. With non-profit organizations and government agencies, there has been an increasing need for performance audit, examining their success in satisfying mission objectives of business.

In India, the Companies Act, 2013 has made the audit of company accounts mandatory. With a sharp increase in the size of the companies and the volume of transactions day in and day out, the objective of auditing has changed. Now, auditing relies on fair representation of the financial efforts. The Companies Act, 2013 also prescribes for a qualification of the auditor. W.E.F from April 1, 2014, due to the amendment in the Companies Act, 2013 detailed provisions on cost audit, internal audit and secretarial audit can be found in the Act.

1.3 INTRODUCTION TO AUDITING

Economic decisions, whether made by individuals, businesses, or institutions like banks, are based on the information available at the time of the decision. This information includes financial data, market conditions, and various other relevant factors. For economic decisions to be sound and effective, the information used in the decision-making process must be reliable, relevant, understandable and comparable. This means that the data should be accurate, up-to-date, and free from manipulation or misrepresentation. Reliable and relevant information enables decision-makers to allocate resources efficiently. In the context of the bank's lending decision, if the financial statements are accurate and transparent, the bank can make an informed assessment of the borrower's creditworthiness and the potential risks associated with the loan. Unreliable information can lead to inefficient resource allocation and negative consequences for both decision-makers and society as a whole. In the lending example, if the bank relies on misleading financial statements, it may grant a loan to a business that cannot repay it, resulting in financial losses for the bank and missed opportunities for other businesses in need of funds. To mitigate the risks associated with unreliable information, there are often regulations and ethical standards in place governing the preparation and disclosure of financial statements and other critical economic data. These regulations aim to promote transparency and accountability.

As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring that the information is sufficiently reliable for these decisions. 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.

1.4 Meaning of Auditing

According to AAS-1 an audit is an independent examination of financial information of any entity, whether profit oriented or not. Irrespective of its size or legal form, such an examination is conducted with a view to express an opinion thereon. The person conducting audit is known as the auditor, he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflects a true and fair view. It is a systematic process to analyse the economic condition and actions of a concern. The auditor examines the documents of the concern, with the help of statements, vouchers, information and comments received from the authorities, so as to confirm the authenticity of financial accounts prepared for a fixed term and report that:

- The balance sheet unveils an accurate and fair view of the state of affairs of the concern;

- The profit and loss accounts disclose the right and balanced view of the profit and loss for the financial period;
- The accounts have been prepared in accordance with the law.

1.5 Origin and Evolution of Auditing

The word 'Audit' is derived from the Latin word "Audire" which means 'to hear'. In olden days, whenever the owner of the business suspects the frauds, they appoint independent and impartial person who uses to hear the explanation given by the accountant. Such person was known as 'Auditor'. Auditing is as old as accounting and there are signs of its existence in all ancient cultures such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. Arthshastra by Kautilya also detailed the rules for accounting and auditing of public finances. The Mauryas, the Guptas and the Mughals had developed the accounting and auditing system to control state finances. Thus, basically, accounting and auditing had their origin in the need for the government to control the income and expenditure of the state and the army. The original object of auditing was to detect and prevent errors and frauds.

The last decade of the 15th century was a crucial period during which a great impetus was given to trade and commerce by Renaissance in Italy. The origin of auditing can be traced to Venice, Italy, where around the year 1494, Luca Pacioli published a paper on and introduced the double entry system of bookkeeping and described the duties and responsibilities of an Auditor. However in the field of auditing the first revolution came about in the year 1844 when in England, through the companies act, the presentation of a balance sheet by companies and getting the same audited was given legal recognition. Though earlier shareholders themselves audited the accounts with the help of accountants, however soon it was realized that auditor must be an independent person who has comprehensive knowledge and expertise in accounts. Therefore, in the year 1888, the Institute of Chartered Accountants was set up in England with the aim of preparing qualified *accountants and auditors*.

The Indian Companies Act, 1913, prescribed for the first time the qualifications of an Auditor. The Auditor's Certificate Rule was passed in 1932 to maintain uniform standard in Accountancy and Auditing. On 1st May, 1948, an Accountancy Experts Committee was set up by the government, which recommended that an 'Institute of Chartered Accountants' should be set up through a legal enactment. On the basis of this recommendation the *Chartered Accountant Act, 1949* was passed. The Act regulates that a person can be authorized to audit only when he qualifies in the examinations conducted by The Institute of Chartered Accountants of India. Companies Act 1931 was replaced by Companies Act 1956, which made it mandatory for all the Public and Private Companies to get their accounts audited. Members of Institute of Cost and Works Accountant of India are authorized to conduct cost audit according to **Section 233-B of the Companies Act, 1956. An Auditor can be appointed only by a special resolution as per section 224 The Companies (amendment) Act, 1974.**

1.6 Definition of Auditing

"An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which they purport to relate." –**Lawrence R. Dickey.**

"Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the Auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report."- **The Institute of Chartered Accountant of India (ICAI)**

"Audit such an examination of the books of accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up so as to give a fair and true view of the state of affairs of the business and the whether the profit and loss of accounts gives a true and fair view of profit and loss for the financial period according to the best of his information and explanations given to him and as shown by the books and if not in what respect he is not satisfied." –Spicer & Pegler.

*"Audit is defined as an investigation of some statements of figures, involving examination of certain evidence, so as to enable an auditor to make a report on the statement." –**Taylor and Perry.***

"Auditing is a systematic examination of books and records of a business of other organization in order to ascertain or verify and to report upon the facts regarding the financial operations and the results thereof". — **Montgomery**

"An audit is an exploratory, critical review by a public accountant of the underlying internal controls and accounting records of a business enterprise or other economic unit, precedent to the expression by him of an opinion of the propriety of its financial statements". — **Eric L. Kohler**

Auditing may be defined as "inspecting, comparing, checking, reviewing, vouching, ascertaining, scrutinizing, examining and verifying the books of accounts of a business concern with a view to have a correct and true idea of its financial state of affairs." — **M.L. Shandily**

After analysing the above definitions of auditing an appropriate and complete definition of auditing can be given as follows:

Basically, auditing refers to a critical examination of the books of accounts of the business, carried out by an independent practitioner who is qualified, known as the auditor with the help of vouchers, documents, information and explanations, so as to satisfy himself regarding the authenticity of financial accounts.

Therefore, we can draw the following facts in connection to the audit.

- Checking of books of accounts and documents of evidence on the basis of generally accepted principles and procedures.
- Checking of works performed by the staff whether they have performed within the limits of authority or not.
- Checking the books of accounts whether the results presented by profit and loss account and financial position presented by balance sheet are true and fair or not.
- Preparation of report based on the fact found during the course of an audit.

1.7 Features of Auditing

i. **Independence:** Auditors must maintain independence from the entity being audited to ensure impartiality and objectivity. This independence is crucial to provide unbiased opinions and assessments.
ii. **Systematic and Structured Process:** Auditing follows a well-defined and structured process. Auditors typically adhere to established auditing standards, procedures, and guidelines to ensure consistency and thoroughness in their work.
iii. **Evidence-Based:** Auditing relies on the collection and evaluation of evidence. Auditors gather relevant documents, records, and information to support their findings and conclusions.
iv. **Professionalism:** Auditors are trained professionals with expertise in accounting, finance, and auditing principles. They adhere to ethical standards and professional codes of conduct in carrying out their responsibilities.
v. **Objective Assurance:** Auditing provides an independent and objective assessment of the subject matter under review. The goal is to provide reasonable assurance that the information or operations are free from material misstatements, errors, or irregularities.
vi. **Materiality:** Auditors focus on material matters, which are items or issues that could have a significant impact on the financial statements or the subject matter being audited. Immaterial issues are generally not a primary concern.
vii. **Scope:** Auditing can have different scopes, such as financial audits, operational audits, or compliance audits, depending on the specific objectives and areas being examined.
viii. **Professional Judgment:** Auditors often need to exercise professional judgment when interpreting evidence and making assessments. This judgment is based on their experience, expertise, and the specific circumstances of the audit.
ix. **Reporting:** After completing the audit, auditors provide a report that communicates their findings, conclusions, and recommendations (if any). The report is typically addressed to the intended users, such as shareholders, management, or regulatory authorities.
x. **Confidentiality:** Auditors are required to maintain the confidentiality of information they obtain during the audit process, except in specific circumstances where disclosure is required by law or professional standards.

xi. **Risk Assessment:** Auditors assess the risks associated with the subject matter being audited. This includes identifying areas of higher risk that may require more extensive testing and scrutiny.

xii. **Communication:** Effective communication between auditors and the entity being audited is essential. Auditors often interact with management and other stakeholders to gather information and clarify issues.

xiii. **Continuous Improvement:** Auditing processes are continually evolving to adapt to changing business environments, technologies, and regulatory requirements. Auditors seek ways to enhance the effectiveness and efficiency of their procedures.

xiv. **Compliance with Standards:** Auditors adhere to recognized auditing standards, which may vary depending on the type of audit (e.g., Generally Accepted Auditing Standards in the United States, International Standards on Auditing globally).

xv. **Documentation:** Auditors maintain detailed documentation of their audit work, including the evidence gathered, procedures performed, and conclusions reached. This documentation provides a record of the audit process and supports the audit report.

1.8 Objects of Auditing

The objectives of auditing are changing with the times. Earlier, the business was simple and object of auditing was only to check the correctness of receipts and payments. Now, with the advancement of business techniques, the objectives of auditing have also changed. The main object of auditing is to see whether the balance sheet and profit and loss account have been prepared properly in accordance with the provisions of the company law and whether they present a true and fair picture of the financial position of the company.

Certain frauds and errors may be detected in the process of this ascertainment. However, the detection of errors, frauds and irregularities is incidental to the main objective. It is a subsidiary advantage or benefit flowing from the audit.

From the point of view of convenience, the objectives of auditing can be divided into three categories:

1.8.1 Main Objects of Auditing

The main object of audit is to know whether the accounts are true and complete and have been maintained according to rules.

As per Section 227 of the Companies Act, 1956**, / Section 139 to 148 of** Companies Act, 20133 ***the main object of auditing is to state whether the accounts give a "true and fair view"*** in case of balance sheet, of the financial state of affairs of the company at the end of financial year and in case of profit and loss account, of the profit or loss for its financial year.

The primary objectives of auditing may be stated as under:

- The verification of the correctness of the books and records leading to a final account or statement submitted to the real proprietors.
- The ascertainment that the business has been carried on in accordance with statutory or other legal regulations.

- Ascertain that proper accounting principles and procedures and management policies are followed.
- Report on the Balance Sheet as to whether it reflects the true and fair state of affairs of the business and that the Profit and Loss Account shows the correct profit or loss of the business.

1.8.2. Subsidiary Objects of Auditing

The subsidiary objects of audit may be stated as follows:

1.8.2.1 Detection of Errors: Generally, errors are the result of carelessness or ignorance on the part of the persons preparing the accounts. An auditor should be very careful about it, because sometimes, errors which might appear as innocent are the results of fraudulent manipulation. For example, a debtor sends Rs. 5000 by bank draft and the accountant forgets to make an entry in the books; it is an error. On the other hand, if the accountant intentionally keeps the money with him and spends it for his own use and does not make an entry in the books it becomes a fraud. Thus, an auditor must pay particular attention to it. Errors may be of following types:

i. **Errors of Commission:** An error of commission takes place when a transaction is incorrectly recorded, either wholly or partially. Such errors arise in the following ways:
   a. Error of Recording,
   b. Error of Posting,
   c. Error of casting or Error of Carry-forward.

a. **Error of Recording**: The error arises when any transaction is incorrectly recorded in the books of original entry. This error does not affect the Trial Balance.

   Example – 1: Goods purchased from Sita for Rs. 1000 wrongly recorded in Purchases Book as Rs. 100.

   Example – 2: Goods purchased from Tarun for Rs. 1,000, instead of entering in Purchases Book wrongly entered in Sales Book.

b. **Error of Posting**: The error arises when a transaction is correctly journalised but wrongly posted in ledger account.

   Example – 1: Rent paid to landlord for Rs. 10,000 on 1.5.2016 is wrongly posted to debit side of Repairs account instead of debit side of Rent account.

   Example – 2: Rent paid to landlord for Rs. 10,000 on 1.5.2016 is wrongly posted to credit side of Rent account instead of debit side of Rent account.

c. **Error of casting or Error of Carry-forward**: The error arises when a mistake is committed in carrying forward a total of one page on the next page. This error affects the Trial Balance.

   Example – 1: Purchases Book is totalled as Rs. 10,000 instead of 1,000.

   Example – 2: Total of Purchases Book is carried forward as Rs. 1,000 instead of Rs. 100.

ii. **Errors of Omission:** Errors of omission arise due to clerical mistake. If a transaction has not been entered in the books accounts, wholly or partially, it is an example of errors of omission where a transaction is altogether omitted from the record, the error may be difficult to detect. Because, as the transaction has not be posted to the ledger, it will not affect the agreement of trial balance For example, if a credit purchase is not entered in the Purchase Day Book, it will not be posted to the related ledger account, name on the debit side of the Purchases Account and on the credit side the Supplier's Account. The trial balance will not be affected by the omission. An error of this type can only be detected by an intensive checking of the Purchases Book and the Stock Book. However, if a transaction has been partially recorded in the course of its posting to the ledger, the error can be easily detected because it will throw out the trial balance. For example, if a credit sale has been credited to the Sales Account but not debited to Buyer's Account, the trial balance will show excess credit by amount of the sale and then it should not take long to discover the error.

iii. **Errors of Principles:** When principles of book-keeping and accountancy are not followed in the treatment and recording items of a transaction, it is termed as errors of principle. These are sometimes committed intentionally to falsify and manipulate accounts with an objective of showing more or less profits than their actual figures. The following are some of the examples of such types of errors:

a. **Where Items of revenue expenditure are shown as capital expenditure or vice-versa:** For example, some furniture was purchased by a furniture merchant for the purpose of sale and the furniture account was debited. In this case, the furniture is purchased for the purpose of sale, so it is revenue expenditure; therefore, the purchase account should be debited instead of furniture account. Thus, in this case, the error of principle would arise.

b. **Posting an Item of Revenue or Expenditure to a Personal Account:** If rent paid to landlord is posted to the debit of his personal account, it is an example of error of principle, due to which profits would be inflated and the Balance Sheet would be wrong.

c. **Where valuation of assets is not as per generally accepted accounting principles:** It may be done to overstate or understate the profits and financial position of the business concern.

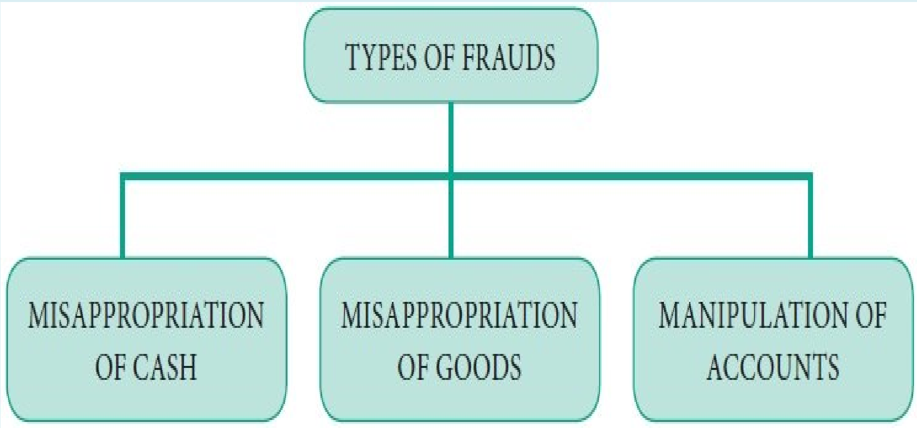
d. **Providing inadequate or excess depreciation:** Such errors are not disclosed in the trial balance and these can be detected by thorough checking of each and every transaction.

iv. **Compensating Errors:** A compensating error is one which is counter-balanced by another error or errors. In other words, when the effect of one error is nullified by another error, then it is called compensating error. If one account is over casted by say Rs. 100 and by chance if another account is under casted by the same, then it is considered as compensating error.

v. **Error of Duplication:** If a transaction is recorded in journal and also posted in ledger twice or more times, the trial balance will agree even though the error may not be disclosed. For example, purchase may be recorded twice with original and duplicate copy of purchase invoice, etc. It is also possible to post the total of any ledger account twice in the trial balance.

1.8.1.2 Detection of Frauds: When something is being done with an intention to mislead, or to deceive or to conceal the truth, it is called fraud. According to SAP-4 issued by ICAI fraud refers to intentional misrepresentation of financial information by one or more individuals among management, employees or third parties. Frauds are more difficult to be detected than unintentional errors. To detect a fraud an auditor has to act very wisely and intelligently. He must know how many types of frauds there can be and must keep them in mind while auditing.

Fig 1.1 Classification of Fraud



Business frauds or Embezzlements are of the following types:

(i) Misappropriation or Embezzlement of Cash: Misappropriation of cash means wrongful conversion or fraudulent application of cash. This can be done by means of suppression of receipts and inflation of payments and wrong castings and embezzlement of cash. Thus money of the business will be fraudulently used to one's own purpose. Misappropriation of cash may be committed in any of the following ways:

a. Non-recording of cash sales.
b. Making false entries in the accounts of customers as regards bad debts, discount, rebate, etc.
c. Entering the cash received from one customer against another.
d. Showing payments against purchases never made.
e. Non-recording of credit notes for purchase returns.
f. Non-recording of bills of exchange discounted.
g. Non recording of cash received against unusual sales, e.g., sale of furniture, junk, substandard goods, etc.
h. Non-recording of unusual money receipts such as donations.
i. Recording payments which are never made.

Example: Cash received on account of cash sales for Rs. 35,000 is accounted in the debit side of the cash book as Rs. 25,000. The difference of Rs. 10,000 may be defrauded by the cashier.

(ii) Misappropriation of Goods: Misappropriation of goods refers to the use of goods of the business for purpose other than that of enterprise. Goods may be misappropriated only by those persons who are in any way connected with the purchase, storekeeping or issue or sale of goods. Such a type of fraud is difficult to detect and usually takes place where the goods are less bulky and are of high value.

There may be misappropriation of goods in the following ways:

a. By showing less amount of purchase than actual purchase in the books of accounts.
b. By showing issue of material more than actual issue made.
c. By showing good materials as obsolete or poor line of goods.
d. By showing fictitious entries in the books of accounts.
e. Stock may be theft.
f. False entry for purchase return is passed and the goods are misappropriated.
g. False entry for sale is made and the goods as shown to be sold are kept by the person committing fraud.

Example – 1: Goods purchased amounting to Rs. 58,000 is wrongly accounted in Purchases Book as Rs. 50,000. Hence, showing lower amount of purchase than the actual goods worth Rs. 8,000 will be misappropriated.

Example – 2: Goods issued from stores for 1000 units is wrongly accounted in the Ledger accounts as 3000 units issued. The difference of 2000 units may be misappropriated by the storekeeper.

Example – 3: Entries in the Purchases Book may be suppressed or inflated to show more or less profit.

Detection of Misappropriation of goods is a difficult task for an Auditor. Only through efficient system of inventory control, periodical stock verification, internal check system and adequate security arrangement the scope for such frauds can be eliminated or minimized. Auditor has to thoroughly scrutinize the inward and outward registers, invoices, sales memos, audit notes, etc., to detect the goods-related frauds.

(iii) Manipulation of Accounts: Manipulation of accounts is usually executed by the high-official of a business in collusion with its owners. Sometimes, employees of lower cadre do so in order to conceal their errors or the fraud of cash or goods perpetrated by them but such manipulations are of trivial nature and their impact on Profit and Loss Account and Balance Sheet is negligible. The manipulation of accounts by the top officials or owners is done either to show profits more than actual or less than actual.

Causes of Manipulation of Accounts

There are different causes for manipulation of accounts. The reasons are:

a. To get more commission calculated on profit.
b. For evasion of income tax and sales tax.
c. To get huge loan from financial institutions by showing more profit in the books of accounts.
d. To declare more dividend to the shareholders.
e. By showing more profit than actual to get confidence of the shareholders.

f. To make secret reserves by showing less income or by showing more expenses in the books of accounts.

Ways of Manipulation of Accounts

Manipulation of accounts may be made in the following ways:

a. By showing more or less amount on fixed assets,
b. By showing over valuation or under valuation of stock,
c. Over or under valuation of liabilities,
d. Creation of over or under provision for depreciation,
e. Charging capital expenditure as revenue expenditure or vice versa,
f. By making more or less provision for bad debts and for outstanding liabilities,
g. By showing advance income or expenditure in the current year accounts.

Objectives of Manipulation of Accounts

The objectives of Manipulation may be window dressing or creation of secret reserves.

Window Dressing: In window dressing, accounts are manipulated in such a manner to reveal a much better and sound financial position of the business than what actually it is, in order to mislead the outsiders by inflating the profit.

Secret Reserves: Accounts are prepared in such a manner that they disclose a worse financial position than the real. The real picture of the business is concealed and a distorted one is revealed.

1.8.2.1Prevention of Errors and Frauds:

The auditor, while auditing, must keep all the possibilities of existence of frauds, misappropriations and irregularities in mind. He must put searching analytical questions and must examine the accounts analytically. The statement on auditing practices issued by the Research Committee of the Institute of Chartered Accountants of India states that "the auditor should bear in mind the possibility of the existence of fraud or other irregularities in the accounts under audit". Further an audit under the companies Act is not intended and cannot be relied upon to disclose all defalcations and other irregularities, their discovery may be incidental to such an audit."

The auditor cannot do anything directly to prevent errors and frauds. After completing the audit work, the auditor can advise his client by making suggestions regarding various ways to prevent errors and frauds in future if he is asked for that. To some extent the fear of audit minimises the chances of errors and frauds. Auditor's visits to check accounts also keep a moral check on the employees engaged in preparing the accounting books. They remain careful because they know that accounts are to be finally audited and any fraud or error will be ultimately detected. Prevention is better than cure. Auditing is got to be done with this view. Some frauds are committed deliberately and so cleverly that it becomes very difficult to detect them. If the auditor makes a detailed checking instead of test checking, he can surely detect frauds.

1.8.2Other Objects

Growing complexities in business and management have necessitated that audit may be used for varieties of purpose, such as audit of efficiency, management policies, performance, costs and so on. Hence, the objects of audit are largely based on as to why it is conducted and what is to be reported by the auditor.

Such objects are called other objects, which can be discussed as follows:

i. **Moral Pressure on Employees:** The visit of auditor put a moral effect on the employees. They become alert and careful which will minimise the chances of errors and frauds. Auditing system proves helpful in developing the habit of working honestly and sincerely among the workers.
ii. **To satisfy the Government Authorities:** The audited accounts of the company and firms are considered reliable by the officers of the government. Audited accounts are considered more reliable for the purposes of various types of taxation and during the course of assessment of income-tax, sales tax, etc.
iii. **To Fulfil the Legal Requirement:** For some institutions auditing has been made compulsory e.g. joint stock companies, banks, finance corporations, insurance companies etc. Thus, object of the audit of a company is to fulfil the provisions of the companies Act.

1.9 Difference between Errors and Frauds

Frauds and errors are quite different from each other. The only similarity is that both fraud and error do not reveal the true picture of the organisation. Main points of difference between fraud and error can be classified as follows:

Table 1.1 Difference between Errors and Frauds

Sl. No.	Basis of Difference	Errors	Frauds
1.	Purpose	Purpose of errors is not to deceive or cause loss to anyone.	Fraud is made to cause loss or to deceive
2.	Intention	Errors are made unintentionally.	Frauds are made intentionally.
3.	Cause	Errors are the result of carelessness or ignorance on the part of the person preparing the accounts.	Frauds are caused by clever and fraudulent persons very widely.
4.	Detection	Detection of errors is comparatively easy.	Detection of fraud is a complicated work. Only an experienced auditor can detect

			fraud.
5.	Result	Result of error is not certain. It may produce profit or loss to the concern.	The result of fraud is certain and it is beneficial for one party and harmful for others.
6.	Offence	Error is not considered as an offence.	Fraud is considered as offence.
7.	Planning	Planning is not made for making errors.	Planning is made for making fraud.

1.10 Advantages and Importance of Auditing

Importance of auditing can be judged from the fact that Audit of accounts is carried out in almost in all forms of business organisations whether it is compulsory or not. Audit of business accounts has now become a necessity rather than being considered as a luxury. The increasing size and sophistication of today's enterprises, the complexities in business transactions, enormous increase in trade, commerce and industrial activities, the employment of hired accountants for writing up accounts, the legal requirements to maintain proper books of accounts for sales tax, income-tax and other purposes, the awareness of the public of the advantages of audit etc., have strengthened the force for audit of business accounts. Advantages of auditing can be studied as follows:

1.10.1 General Advantages: General advantages obtained by auditing are as follows:

i. **Exhibits a True and Fair View of the Financial Statements:** Audited accounts enable to reveal that the Profit and Loss Account and Balance Sheet of the business concern shows a true and fair view of the state of affairs of the business concern.
ii. **Keeps morale check:** Auditing monitors the overall financial dealing of organizations. This prevents the working staff from committing any error and fraud. All employees work efficiently towards their role with a fear that all irregularities will be identified by auditing.
iii. **Assurance of true and fair accounts:** Audit provides an assurance to the various users of final accounts such as owners, management, creditors, lenders, investors, government's etc. that the accounts are true and fair.
iv. **Tally with books:** The audited final account can be taken to tally with the books of accounts. Thus, the income-tax officer can start with the figure of audited books profit, make adjustments and compute the taxable income. An outside user need not go through the entire books.
v. **As per standard accounting and auditing practices:** The audited final accounts follow the standard accounting and auditing principles laid down by professional bodies. Thus, audited accounts are based on objectives standard and not on personal whims and fancies of a particular accountant or auditor.

vi. **Detection and prevention of errors and frauds:** Audited accounts can be assumed reasonably free from errors and frauds. The auditor with his expert knowledge would take due care to see that Errors and frauds are detected so that the accounts show a true and fair view.

vii. **Advice on system, taxation, finance:** The auditor can also advise the client about the accounting system, internal control, internal check, internal audit, taxation, finances etc.

viii. **Helps to determine future trends:** By comparing the audited accounts with past years, the trend of financial activities can be determined. On the basis of review, weaknesses are found out and policies for the future period can be determined.

ix. **Increase in goodwill:** Audit of business on a regular basis increases confidence to the interested parties and general public; as a result goodwill of the business can be enhanced.

1.10.2 Advantages for the Sole-Trader: In addition to the above mentioned advantages, a sole trader has the following advantages:

i. **Helpful in comparative study:** A big sole-trader can know the progress made in his business by making a comparative study of the audited accounts for two different periods.

ii. **Evidence for the Court:** In the case of a dispute, audited accounts can be produced in the court as evidence.

iii. **Helpful in converting into partnership:** When a sole-trader wants to make a partner in his business, then audited accounts prove helpful in the valuation of his business.

iv. **Helpful in ascertaining income tax and other taxes:** Audited accounts can prove helpful in ascertaining income tax and other taxes.

v. **Helpful in ascertaining wealth tax:** After the death of a sole-trader, audited accounts prove helpful for ascertaining wealth tax.

1.10.3 Advantages for Partnership Firms:

i. **Create mutual trust among partners:** All the partners of a firm do not take part in day-to-day activities of the firm. If the accounts of the firm get audited then the partners who do not take part in the activities of the firm, can easily trust on the partners who manage the affairs of the firm.

ii. **Decrease the possibilities of disputes:** Dispute over correctness of accounts and profits can be avoided through auditing of accounts. It creates faith that the terms and conditions of the partnership agreement have been maintained and fulfilled.

iii. **Admitting a new partner:** Audited accounts prove helpful in the valuation of business which facilitates the entry of a new partner.

iv. **Retirement or death of a partner:** Audited accounts are useful in valuing goodwill and value of business on retirement or death of a partner.

v. **Advantage for the Sleeping Partner:** A sleeping partner does not have full knowledge of the business. Audited accounts are very important for him. On their basis, he can know if the business is being run properly or not.

1.10.4 Advantages to Company: In addition to the general advantages, audited accounts give the following advantages to company:

i. **Trust in the performance of management:** Shareholders, who do not know about day-to-day administration of the company, can judge the performance of management from audited accounts. They can value their shares on the basis of audited financial statements.
ii. **Helpful in absorption and reconstruction:** At the time of absorption and reconstruction, the audited accounts of the company are very helpful in removing many doubts. They are helpful in valuation of the business because audited accounts present a true and fair picture of assets and liabilities of the company.
iii. **Helpful in raising capital:** When company wants to raise capital, it issues prospectus along with audited accounts. Public invest money in the shares on the faith of audited accounts.
iv. **Helpful in dividend distribution:** The auditor certifies the profit earned by the company. So, no doubt crop up in the distribution of dividend.
v. **Make trust in the general public:** An auditor acts as a trustee of the shareholders in the case of a joint stock company and safeguards their financial interests. Shareholders are assured that the accounts have been properly maintained and the directors and managers of the company have not taken any undue advantage of their position and have conducted the company affairs in the interest of the whole body of shareholders.

1.10.5 Advantages for Others: Audit safeguards the interests of the owners, creditors, investors and workers. For example, it is generally seen that the audited accounts are useful for settling trade disputes for higher wages or for the payment of bonus to the workers.

1.11 Limitations of Auditing

i. **Gives Opinion:** After the completion of audit, an auditor gives only the opinion regarding true and fair view of the books of accounts and financial position of the business. Therefore, an auditor is not an insurer; he does not give guarantee regarding financial reflections of the business.
ii. **Chances of Undisclosed Errors and Frauds:** An Auditor has to depend on many financial data and statements supplied by the management which may be wrong or misleading. Therefore, there may be some undisclosed errors and frauds in the books of accounts.
iii. **Lack of Proper Care and Skill:** Often it is seen that an Auditor does not apply proper care and skill to verify the books of accounts and take it as a routine matter. As a result, the books of accounts do not reflect true and fair view of the financial position of the business.

iv. **No Evaluation of Managerial Efficiency:** An Auditor is not an advisor; therefore, he cannot give his opinion regarding managerial efficiency because every concern has its own policy, procedures and practices.

v. **Not Preventive:** Audit is a post-mortem examination. The work of audit starts after the completion of transactions recorded in the books of accounts. Therefore, audited accounts can prevent the future activities but not the past.

vi. **Additional Financial burden**: An organization has to bear additional financial burden on account of any fees and other such expenses for conducting an audit.

1.12 Fundamental Postulates of Auditing

Postulates are fundamental truths or assumptions of a theory which are required to be accepted without proof. These assumptions help to explain the meaning of auditing principles. The basic postulates of financial auditing theory as formulated by Mautz and Sharaf in their book "The Philosophy of Auditing" in 1961 is as follows:

i. Application of recognized accounting principles would result in fair presentation.
ii. Financial statements and financial data are verifiable.
iii. The financial statements are free from collusive and other unusual irregularities.
iv. There is no conflict of interest between the auditor and the management of the entity.
v. The existence of a satisfactory system of internal control eliminates the probability of irregularities.
vi. In the absence of clear evidence to the contrary, what was held true in the past for the entity will hold true in the future.
vii. The professional status of an independent auditor imposes commensurate professional obligations.
viii. When examining financial data, the auditor acts exclusively in the capacity of auditor.

1.13 Principles of Auditing

i. **Integrity:**
- Honest and straightforward.
- Auditor not to practice dishonest means for satisfying client's requirement.

ii. **Confidentiality:**
- Not to provide information about the clients to third parties.
- Also covered by CA regulations.
- If required by law, he may disclose information with the consent of client.

iii. **Objectivity:**
- To conduct audit keeping in mind secondary and primary objectives.
- He must be fair and must not allow prejudice or bias to override his objectivity.

iv. **Independence:**

- Should not be capable of being influenced by anybody.
- Relevant for judging opinion on view presented by financial statements.

v. **Skill and Competence:**
- Be capable of applying the skill in practical situation.
- Update and upgrade knowledge in the relevant fields.
- The audit should be performed and the report prepared with due care by professional persons who have adequate training, experience and competence in auditing.

vi. **Audit Planning :**
- Audit must be based on proper planning.
- The plan of audit must be developed before commencement of audit.
- It also includes programming.

vii. **Audit Evidence:**
- Audit must be conducted by considering evidences through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on financial information.
- Evidence is available in the form of books, records and vouchers.
- It is available from internal and external sources.

viii. **Audit Documentation:**
- Auditor to record his observation of findings in working paper.
- To be maintained at Auditor's Office

ix. **Using the Work of Others:**
- Involvement of other experts in the audit of financial statement.
- Auditor to use the work of other intelligently.
- The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

x. **Evaluation of ICS and AS:**
- Client's responsibility to introduce ICS which includes AS.
- Auditor to evaluate the system before commencing audit.
- It is useful for Audit to determine the extent of checking and nature of audit procedure.

xi. **Audit Conclusiveness:**
- Formation of opinion.
- Report in specific format.
- Address to specific authority.
- Adequate disclosure of all material facts.

1.14 Techniques of Auditing

Techniques of auditing mean the procedure and method which is adopted by the auditor in checking the accounts. Following are the important techniques of audit:

i. **Examination of Record:**
This technique is commonly used by the auditors; the inspection of books and documents is made to verity the validity of data.

ii. **Inquiry:**
The auditor can also use the technique of inquiry. He can get the information from resource persons inside or outside the enterprise.

iii. **Sampling:**
Auditor can select few items from whole accounting information. This technique enables the auditor to obtain and evaluate the evidence of some characteristics of the whole class. It is helpful in forming the conclusion.

iv. Confirmation:
To ensure the accuracy of the data auditor can collect the information from the debtor. Confirmation is response to an inquiry to prove certain data recorded in the books.

v. **Compliance:**
To check the arithmetical accuracy of accounting record, the balancing accounts can be compared with the vouchers to test the reliability of data.

vi. **Compliance Test:**
These tests are designed to check the effectiveness and compliance of internal control. In obtaining the audit evidence, auditor is concerned with the existence of effective internal control.

vii. **Use of Computer Techniques:**
There is large number of audit techniques like audit software, test packs and mapping which can be used by the auditor to test the accuracy of the data.

viii. **Substantive Test:**
These are designed to obtain evidence that data produced by accounting system is accurate or not. It has two kinds:
a) Test of detail transaction.
b) Test of significant ratios and trends.

ix. **Dependence on Experts and Auditors:**
The auditor has to rely on the internal and other auditors to complete his work. He has also to rely on other experts like lawyers, engineers and doctors for their expert opinion about the business.

x. **Analytical Review:**
It consists of studying significant ratios, trends and investigating different changes. This review procedure is based on the expectations of relationship among the past and present data.

1.15 Qualities of an Auditor:

An effective auditor possesses a combination of professional qualifications, skills, and personal qualities that are essential for carrying out audit engagements with competence and integrity. Here are some key qualities of an auditor:

i. **Integrity:** Auditors must demonstrate the highest level of integrity and ethical behavior. They must be honest, objective, and independent in their judgments and decisions. Ethical conduct is crucial to maintain trust and credibility.

ii. **Professionalism:** Auditors should exhibit a high level of professionalism in their work. This includes adhering to professional standards, maintaining confidentiality, and conducting themselves in a manner that upholds the reputation of the auditing profession.

iii. **Analytical Skills:** Auditors need strong analytical skills to examine financial data, internal controls, and operational processes critically. They must be able to identify anomalies, irregularities, and areas of risk effectively.

iv. **Attention to Detail:** Auditing requires meticulous attention to detail to ensure that nothing is overlooked during the examination of financial records and documentation. Small errors or omissions can have significant implications.

v. **Technical Expertise:** Auditors must possess a solid understanding of accounting principles, auditing standards, and relevant regulations. They should stay updated on changes in these areas and have the technical knowledge to assess complex financial transactions.

vi. **Communication Skills:** Effective communication is essential for auditors. They need to convey complex audit findings, both in written reports and verbally, to various stakeholders, including management and clients. Clear and concise communication is key.

vii. **Problem-Solving Skills:** Auditors often encounter complex issues and challenges during audits. Strong problem-solving skills are valuable for identifying solutions and making recommendations for improvement.

viii. **Independence:** Auditors must maintain independence from the entity being audited to ensure objectivity and impartiality. This includes both independence in fact and independence in appearance.

ix. **Time Management:** Auditing engagements often have tight deadlines. Auditors must manage their time efficiently to complete audits within the established timelines while maintaining the quality and thoroughness of their work.

x. **Risk Assessment:** Auditors need the ability to assess and evaluate risks associated with financial statements, internal controls, and operations. This includes identifying potential fraud risks and compliance issues.

xi. **Curiosity:** A curious auditor is more likely to uncover irregularities or areas of concern during an audit. A willingness to ask questions and dig deeper is a valuable quality.

xii. **Teamwork:** In larger audit firms, auditors often work as part of a team. The ability to collaborate effectively with colleagues and share information and findings is essential.

xiii. **Adaptability:** Auditors should be adaptable and open to change. The business environment and audit methodologies can evolve, and auditors need to stay flexible and willing to learn.

xiv. **Confidence:** Auditors need to have confidence in their abilities and judgments. This confidence helps in making decisions and standing by their findings, even in challenging situations.

xv. **Cultural Sensitivity:** In a globalized world, auditors may work with clients from diverse cultural backgrounds. Being culturally sensitive and aware of cultural differences can aid effective communication and understanding.

xvi. **Resilience:** Auditing can be demanding and stressful. Auditors must possess resilience to cope with pressure, tight deadlines, and the potential for difficult audit situations.

1.16 Chapter Conclusion

In conclusion, auditing is a vital process that plays a critical role in ensuring the accuracy, transparency, and trustworthiness of financial information and operational processes within organizations. Auditing serves a range of objectives, including providing assurance to stakeholders, evaluating compliance with laws and regulations, assessing internal controls, and detecting fraud or errors. The key features and qualities of auditing, such as independence, professionalism, analytical skills, and integrity, are essential for auditors to carry out their responsibilities effectively.

Auditing not only benefits individual organizations but also contributes to the overall stability and reliability of financial markets and the broader economy. It helps maintain accountability, supports informed decision-making, and identifies areas for improvement in business operations.

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