Indo-American College, Cheyyar,
III B.Com – Practical Auditing

UNIT: I

Meaning and definition of auditing – Nature and Scope of auditing – Accountancy and Auditing; Auditing and Investigation – Objectives of Auditing – Limitations of auditing – Advantages of Auditing – Classification of Auditing.

INTRODUCTION OF AUDITING

The origin of auditing can be traced to Italy. Around the year 1494, Luca Paciolo introduced the double entry system of bookkeeping and described the duties and responsibilities of an Auditor. The concept of auditing dates back to ancient Egyptian, Roman and Greek civilizations, where commercial transactions were systematically checked and counter checked by financial administrators, In India, pre-vedic literature makes references to the existence of well developed system of accountancy.

DEFINITION OF AUDITING;

Auditing in India has been described in different ways −

"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

Sri Kamal Gupta, with his practical experience in auditing says, "Auditing involves evaluating the effectiveness of internal control procedures, examining in depth scientifically selected samples of transactions and applying analytical procedures.

According to Montgomery; "Auditing is a systematic examination of the books and records of a business or the organization to ascertain or verify and to report upon the facts regarding the financial operation and the result thereof".

Following are a few other points related to Auditing in India −

- 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.
- Companies Act 1931 was replaced by Companies Act 1956.
- An Auditor can be appointed only by a special resolution as per section 224 The Companies (amendment) Act, 1974.

SCOPE OF AUDITING

In comparison with earlier days, where the main objective of auditing was to detect fraud, we now have enhanced ways to determine a true and fair view of financial statements. In recent times, almost every country of the world has introduced various legislations and framed rules and regulation of auditing. In India also legislations related to Tax Audit, Cost Audit, Management Audit and operation Audit, etc. are coming up.

The main purpose of auditing is to certify the correctness of financial statements and to detect errors and frauds. The audit should cover all material aspects which are concerned with the relevant financial statements.

Before forming an opinion, an auditor should be convinced that underlying records and other documents which form the basis for preparing the financial statements are reliable and sufficient. The auditor should also be satisfied that all information required to be disclosed under law is properly disclosed.

FEATURES OF AUDITING

- The purpose of audit may vary. An auditor may be called upon to evaluate the performance of the organisation or he may be required to verify the effectiveness of internal control or he may be called upon to review,the financial statemetns of an organisation to give an opinion, whether the statement shows true and fair view of the state of affairs of the organisation.
- Auditing involves use of specific techniques ,standards and producers .
- To conduct an audit, a person should be professionally competent,possess in depth theoretical knowledge and extensive practical training.
- The nature or size of an organization should not affect the opinion on the financial statements.
- While conducting the audit the auditor should satisfy himself that-
  a)the financial statements are based on the entries made in the books.
  b)there are adequate documents supporting the entries made in the books.
  c)all entries in the books are included while preparing the financial statements and no transaction is included in the financial statements which is not found in the books.
  d)the explanation and information provided are adequate .
  e)accounting standards are followed while preparing the financial statements.
  f)The financial statements give a true and fair view of the state of affairs of the bussiness.

ACCOUNTANCY AND AUDITING

Accountancy

Accountancy involves recording of all transactions having financial character and classifying,summarising and interpreting the activities of the organisation for a particular period by preparing profit and loss account and balance sheet.

Auditing

It is commonly said that the" auditing begins where accountancy ends".During auditing ,an auditor verifies the authentically of all the transactions by scrutinising the supporting documents and gives his opinion on the financial statements –whether they show the true and fair view of the state of affairs of the organisation.

Difference between accountancy and auditing

Accountancy	Auditing
1. Accountancy is concerned with the preparation of accounts and financial statements.	1. Auditing is concerned with examining the accounts and reporting on financial statements.
2. An accountant is an employee of the organisation and is appointed by the management.	2. An auditor is an independent person and he is not an employee of the organisation. In the case of companies, he is appointed /reappointed in the case of companies.
3. An accountant need not have the knowledge of auditing.	3. An auditor should be endowed with a thorough knowledge of accoounting and auditing.
4. The work of the accountant is influenced and afected by the interference of the management.	4. An auditor acts independently and his work is free from any interference.
5. Maintenance of accounts is inevitable to run a business	5. Auditing is not inevitable and only under certain circumstances auditing is made compulsory by certain statutes like Companies Act, Income Tax Act etc.

Key Differences Between Auditing and Investigation

The following are the major differences between auditing and investigation:

1. The process of inspecting the financial statement of an entity and then giving an independent opinion on it is known as Auditing. A careful and detailed study of the books of accounts to discover truth is known as Investigation.
2. Auditing is a general examination while Investigation is critical in nature.
3. The evidence obtained from audit process are persuasive. Conversely, the nature of evidence obtained from Investigation process is conclusive.
4. Auditing is conducted every year, but Investigation is conducted as per the needs of the organisation.
5. Auditing is performed by the auditor whereas an expert team does the performance of an investigation.
6. Auditing is compulsory for every company. On the other hand, the investigation is discretionary.
7. Auditing verifies the true and fair view of the financial statement while Investigation is performed to establish a fact.
8. the appointment of an auditor is made by the shareholders of the company. As against this, an investigator is appointed by the owners/management or one-third party.
9. The scope of auditing is general, which attempts to give an opinion on the financial statement of the company. On the contrary, the scope of the investigation is limited as it attempts to answer only those questions that are asked in the engagement letter.

Conclusion

Auditing is a general process which is common for all the organisation, as it is performed annually. It can be performed either the internal auditor or external auditor. The internal auditor is an employee of the organisation who is appointed by the management while the government appoints the external auditor.

The investigation is quite rare, as it is not commonly performed in any organisation. An expert team is brought to the organisation to conduct it and report the relevant facts. The audit report is submitted to the interested parties like shareholders, creditors, government, suppliers, management, etc. whereas the investigation report is handed over to the party who organised the investigation.

OBJECTIVES OF AUDITING

1) Primary objective -

- To examine the accuracy of books of account
- To express opinion on the financial statements

Primary objective of Audit is to examine the validity and reliability of financial statements so as to render an opinion of the truth and fairness of the presentation of those statement.

According to Section 227 companies act 1956, the main objective is to give 'Truth and fairview'

2) Secondary/Subsidiary objective -

A- Detection of error - Errors may arise at different stages of bookkeeping. According to Institute of Charted accountant of India 'Error is an **unintentional mistake** in the books of account. Errors has been categorized into two parts :

a). **Clerical or Technical errors -** The errors which may occur due to carelessness of staff during posting, balancing and totalling of the accounts. Types:

- **Error of omission-** Arises when any transaction is omitted wholly or partially from being recorded in the books of account.
- **Error of commission** - Occurs due to incorrect records made in the books of account say wrong entries, posting, casting, calculations etc.
- **Error of duplication** - Occurs when the same entry is posted twice in the original book of account and twice in ledger.
- **Compensating error** - Arises when they are counter balanced, when they counterpart each other.

b) **Error of principle** - They arises when the transaction are not recorded in the books of account according to the fundamental and accepted principles of accountancy.

B- Detection of fraud - Fraud means false representation made intentionally. The fraud has to be detected in early stage otherwise it would be difficult to trace.

This gets done by three methods :

a) Misappropriation of Cash - How it usually be done:

- Cash sales may not be recorded
- Record of credit sales may be omitted
- Showing payment against purchase never made
- Concealing cash received from various sources

b) Misappropriation of goods - It may take place in case of goods in less bulky but more valuable. A continuous vigilance is always maintained over the issue of material, record of sales, purchase and stock.

c) Manipulation of account - Account could be manipulated in order to show less or more profit. It is generally perpetrated by director, manager or other responsible officials.

C - Prevention from error and frauds **-** Auditor cannot prevent error or fraud completely, but can put some moral check upon the staff by making them always alert.

He should make detailed study analysis and evaluation of internal control system of the enterprise and find out its weakness then offer suggestions accordingly.

Advantages of auditing

1] Assurance to the Owners/Investors

One of the biggest advantages of auditing is that it offers assurances to the owners, investors, shareholders etc. The owners of the business will be assured about the accuracy of their books of accounts.

They will be satisfied with the workings of their various departments and the overall efficiency and profitability of their business operations. It is the same case with investors, who will find assurance in the books of accounts after auditing.

2] Errors and Frauds

An error is something that is done without the intention to fraud the company, it is an innocent mistake. Fraud, on the other hand, is deliberate. During the process of auditing, both errors and frauds are discovered. Auditing also helps prevent such errors and frauds. It creates a fear of being detected.

So auditing helps us minimize the risks of errors and frauds in our books of accounts but does not eliminate the risk entirely. There is always the chance that the error may go unnoticed, and the fraud is very cleverly hidden so may go undetected.

3] Independent Viewpoint

If the auditor is an external auditor, the business can get a second opinion on their financial statements and their financial standing as well.

An external auditor will closely inspect the books and be completely true and fair in his opinion as he has no hidden agenda. If he says the accounts are true and fair, it has a lot of weightage with the company and the investors.

4] Moral Check

One of the other advantages of auditing is that the staff and the workers of the company do not try to steal or defraud the company. They are under constant scrutiny since they know that the accounts will be audited. Any irregularities can be identified during such an audit, and they will be caught eventually. This helps the staff in being honest and responsible at all times.

5] Stakeholders Confidence

After auditing stakeholders like creditors, investors, banks, debenture holders etc. can rely on the books of accounts with more confidence. And so after auditing by an independent authority, the financial statements have more credibility.

Limitations of Auditing

1] Cost Factor

A very thorough and detailed audit would be a costly affair. It is not cost effective. So the auditor has to limit the scope of his audit and use techniques like sampling and test checking.

2] Time Factor

Auditors generally work on a very specific timeline. Sometimes this is due to statutory requirements. This means he has to audit a whole year's accounts in a few weeks. Hence insufficient time is one of the main limitations of auditing.

3**] Inconclusive Evidence**

Generally, the audit evidence the auditor collects is persuasive in nature, not conclusive in nature. So there is never cent percent conclusive evidence in most cases while auditing.

This is one of the major limitations of auditing. There also a lot of use of estimates in accounting. The auditor cannot measure or comment on the exact accuracy of these estimates. He has to rely on his knowledge.

CLASSIFICATION OF AUDIT

1. External Audit

The external audit is referring to the audit firms that offer certain auditing services including Assurance Service, Consultant Service, Tax Consultant Service, Legal Service, Financial Advisory, and Risk Management Advisory.

The best example of external auditing services is the services that providing by these big four audit firm including KPMG, PWC, EY and Deloitte.

External auditors are normally referring to audit staffs who are working in audit firms. The positions are ranking from audit associate, senior auditors to audit partners as well as managing partners.

The firms are working independently from auditing clients that they are auditing and if the conflict of interest has occurred, proper procedures are needed to take action to minimize the conflicts.

The firm should consider withdrawing from the audit engagement if the impairment could not minimize to the acceptable level.

Some external audit firms are also offering internal audit services. The popular services that offer by external audit firms are an audit of financial statements, tax consultant, and advisory services.

2. Internal Audit

Internal Auditing is an independence and objectivity consulting service that is designed to add value to the business and improve the entity's operation.

It provides a systematic and disciplined approach to evaluating and assessing the entity's risk management, internal control, and corporate governance.

Scope of internal audit is generally determined by the audit committee, the board of directors or directors that have equivalence authorization. And if there is no audit committee and board of directors, internal audit normally reports to the owner of the entity.

Internal audit activities are normally covered internal control reviewing, operational reviewing, fraud investigation, compliant reviewing, and other special tasks assigned from the audit committee or BOD.

3. Forensic Audit

The forensic audit is normally performed by a forensic accountant who has the skill in both accounting and investigation.

Forensic Accounting is the type of engagement that undertaking the financial investigation in response to a particular subject matter, where the findings of the investigation normally are used as evidence in court or conflict resolution among the shareholders.

The investigation is covering numbers of areas include fraud investigation, crime investigation, insurance claims as well as a dispute among shareholders.

A forensic audit is also needed to have a proper plan, procedure, and report like other audit engagement.

Forensic audit also needs to follow ethical guideline like an audit of financial statements. This kind of engagement is not so popular as an audit of financial statements or statutory auditing.

4. Statutory Audit

Statutory audit is referring to an audit of financial statements for the specific type of entities required by law or local authority.

For example, all banking sectors required their financial statements to be audited by qualified audit firms authorized by their central bank.

The statutory audit might be the difference from financial statements auditing as the financial audit is referring to the audit of all types of entity's financial statements including both meet or not meet the government's requirement.

However, statutory audit refers to only auditing of the entity's financial statements that required by local law.

The statutory audit is normally performed by external audit firms and the audit report will be issued by the auditor and submit to the government body by the entity.

The best example of the firms that offering statutory auditing is KPMG, PWC, EY, …. etc.

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5. Financial Audit

Financial audit refers to the audit of the entity's financial statements by an independence auditor where audit opinion will be provided on those financial statements after auditing works are done.

Financial audit normally perform by an external audit firm that holds a CPA and it is normally performed annually and at the end of the accounting period. This type of audit is also known as financial statements auditing.

6. Tax Audit

Tax audit is a type of audit that performing by the government's tax department or tax authority.

A tax audit could be performed as the result of in-compliant found by a government agency or the schedule set by the government tax department.

An entity needs not to invite or engage with the tax authority to come to perform a tax audit. They will come by themselves. Entity just needs to file its tax obligation properly and timely based on the tax law of the country.

To minimize the penalty as the result of the tax audit, the entity is recommended to follow all the requirements set by tax law and for those areas that they are not sure, the entity should engagement with tax consulting firm for advising.

7. Information System Audit or Information Technology Audit (IT Audit)

An information system audit is sometimes called an IT audit. This type of audit assesses and checks the reliability of the security system, information security structure, and integrity of the system so that the output that the system produces is reliable.

Sometimes, financial auditing also requires to has IT auditing as now technology is increasing and most of the client's financial reports are recording by complex accounting software.
The audit approach also changed due to the changing of management's approach in recording and reporting their entity's financial information.
Normally, before relying on information systems (software) that use for producing financial statements, auditors required to have IT, audit teams, to test and review that information system first.
Especially, when an entity uses an ERP system where the operational reportings are also integrated with the accounting system. For example, banking system normally links between operational reporting with the accounting system.
IT audit is also offered and requests separately from the financial audit.
Most of the big firms have this kind of service. They do not only provide IT audit but also offering consultant on the information system areas.

8. Compliance Audit

A compliance audit is a type of audit that checks against internal policies and procedures of the entity as well as law and regulation where the entity operating in. Law and regulation here is referring to the government's law where the business is operating.
For example, in the banking sector, there are many kinds of regulation required bankers to follow and comply with.
Most of the central banks required commercial banks to set up the complaint review (assessment) or compliance audit to make sure that they are complying with those laws and regulations set.
The entity may also assign its internal audit function to review whether the entity's internal policies and procedures are complying and effectively follow.
A compliance audit is part of the system that use by the entity's management to enforce the effectiveness of the implementation of the government's law and regulation, and the entity's internal policies and procedures.

12. Integrated Audit

Integrate audit is happen when there are two different areas of audit requirements. For example, there is a financial audit along with a social audit or there are some areas need to be confirmed with the financial audit.
For example, the NGO requires their financial statements to be audited along with technical areas that those NGO spending the money for.
For example, NGO are working on public health and most of the money spend are related to public health.
Besides the expenses reports that present the expenses that NGO paid for and need to be audited by the financial auditor, there is the number of technical reports like health reports which need to be verified by technical auditors that have experienced in assessing health report.
This is called an integrated audit. The integrated audit also happens when the entity operates in many different countries and the financial statements are an audit by different audit firms.

13. Special Audit

A special audit is a type of audit assignment that normally done by the internal auditor. This has happened when there is the problem/case occurred in the organization like fraud, business case or other special cases.

For example, there is fraud occurred in the payroll department and this concern raised to the audit committee or board of director or sometimes there is the request from the CEO to have a special audit on these areas.

The special audit is a bit different from the forensic audit as a special audit done by the internal staff of the entity.

Once the auditor completes the audit, then the report is prepared by the audit team and then submit to audit committee or board of directors. It is sometimes also reported to the CEO of the entity.

14. Operational audit

Operational audit is the type of audit service that the review is mainly focused on the key processes, procedures, system, as well as internal control which the main objective is to improve productivity, as well as efficiency and effectiveness of the operation.

Operation audit has also targeted the leak of key control and processes that cause waste of resources and then recommend for improvement.

Operational audit is the part of the internal audit and their main aim is to add value to the business their professional services.

Systematic and highly discipline is also the part that helps to make sure the operational audit adds value to the organization.

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