Unit 1 ❐ Auditing

Structure

1.0 Objectives

After reading and studying this unit a learner should be able to :

- Understand the conceptual framework of auditing with reference to its nature, scope and process.
- Explain the objectives of auditing.
- Provide a relationship between accounting and auditing principles.
- Get ideas of various types of audit
- Analyse the extended meaning of audit and its philosophy.
- Evaluate audit as a social science.
- Describe the social objects of audit.

1.1 Introduction

The development of accounting system had necessitated the emergence of a new area, known as auditing. Accounting takes into consideration the measurement, recording and disclosure aspect of a transaction with the objective of giving various financial information through financial statements to the owners of a concern and also to the users, money lending institutions, regulators and other stakeholders. In doing so an accountant has to follow various rules, regulations, principles, statutes, standards, laws, bye-laws, customs etc. But for ensuring its true and fairness, adequacy of disclosure, appropriateness, transparency as regards the financial effects, reliability and acceptability an independent examination is needed and for that the process applied is termed as auditing. So auditing in its simple form can be claimed to have been originated almost simultaneously with the development of organised system of accounting. In the process of its evolution a number of socio-economic and technological events have influenced the course of developments of auditing. Industrial revolution as coupled with change in economic policy also have caused far-reaching changes in techniques, reporting standards of the financial information which in turn has added a new dimension in the status and responsibility of the auditors. Again, with the advent of computers the method of processing information has completely changed. As a result the auditors has been forced to change their approach to auditing and now in a computerised environment the auditor has to place mo Cre emphasis on evaluation of systems, procedure, controls and on analytical procedures. Further the emergence of corporate governance and its compliance has created monumental importance to the subject of auditing. Besides, because of the change in attitude towards social responsibility from mere profit earning motive of the business houses the vision of the auditors has also changed to include in its purview the social and environment aspects of economic activities for sustainable developments of the society. So keeping in view all these aspects the fundamental and basic aspects of auditing including its social objectives is discussed in this unit.

1.2 Nature, Scope and Audit Process

Auditing relates to verification of accounting and financial data with a view to reporting on the reliability of financial statements. It has generally been associated with only accounting and financial records. This verification of data involves a careful evaluation of evidence, both internal and external, either available or which an auditor collects, obtains during the course of audit. According to Mautz "Auditing is concerned with the verification of accounting data for determining the accuracy and reliability of accounting statements and reports." The emphasis is to clearly on the verification of accounting data for the purpose of making an opinion and to the reliability and acceptability of the accounting and financial statements.

The scope of audit of financial statements is determined with reference to the terms of engagement, the requirement of the relevant legislation and the various pronouncements of the Institute of Chartered Accountants of India (ICAI). For forming an opinion all aspects of the enterprise to be concerned as far as they are relevant to the financial statements being audited.

As per Auditing and Assurance Standard (AAS) 1 of the ICAI "An audit is the independent examination of financial information of any entity whether profit oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon". So, as per the definition an audit consists of the following :

- Competent independent person.
- Examination of financial information which encompasses financial statements.
- Entity—may be business entity or other concern like school, college, library, charitable trust owned privately or by the Government and created as per any law, act etc.
- Expression of opinion through the medium which is called audit report.

So, it is clear that auditing process involves evaluating the reliability, relevance and adequacy of evidence in support of the varifiable financial information.

The industrial growth because of new liberalised economic policy has again extended the scope of auditing remarkably. Now auditing is no longer concerned only with financial information it also involves review of compliance with law, costing records, operations and managing performances. It is important to mention here that scope of an audit in relation to matters prescribed by law or by any pronouncements of the ICAI cannot be restricted by the appointing authority through terms of engagements.

Auditing is thus a process by which competent individuals collect and evaluate evidence to form an opinion and communicate his opinion to various interested persons through his audit report. So, the auditing process involves the following components :

- Auditor
- Books of Accounts / Records / Statement
- Auditing procedure / practices

Auditors in India are the practising chartered Accountants who are legally competent to conduct auditing.

Books of Accounts which are prepared by an entity in accordance with the Generally Accepted Accounting Principles (GAAP) covering accounting standards, requirements of companies act and other relevant acts and related laws.

Auditing procedure implies the standard methods, systematic way by which the audit work should be conducted for discharging the responsibility effectively and assuring best quality services. In India the ICAI issues time to time standard auditing practices which is called ''Auditing and Assurance Standards'' (AAS) which an auditor must comply whenever an audit work needs to be carried out.

1.3 Objective of audit

The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to obtain sufficient audit evidence on which to base his independent opinion on the financial statements being audited. In the case of an audit under statute, the auditor must comply with all the duties laid upon him by the relevant statute, and in the case of private audits he must fulfil all the terms of his agreements with the client. In particular, it must be recognised that auditors have duties in relation to the prevention and detection of fraud and error. Where an auditor fails to discover a fraud or error which should have been brought to light by sound auditing technique he could be held to be liable for negligence. Under modern conditions, organisations have also to promote public interest, discharge social responsibilities rather than only looking into the private gain of the investors for all round development of the society which need to be ensured by the auditor in the course of audit.

Thus the objectives of an audit are :

A. Independent review of the financial statesments and making of opinion towards its true and fairness :

The Auditing and Assurance Standard 2 (AAS 2) describes the overall objective and scope of the audit of general purpose financial statements of an enterprise by an independent auditor. According to this standard the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements which in turn help determination of the true and fair view of the financial position and operating results of an enterprise. The auditor is responsible only for forming and expressing an opinion on the financial statements while the responsibility of its preparation lies on the management of the enterprise including maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. It is also important to mention here that the auditor's opinion is not an assurance to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

B. Responsibility towards fraud and error :

Auditing and Assurance Standard 4 (AAS 4) on "The auditor's responsibility to consider fraud and error in an audit of financial statements" discusses the auditor's responsibility with respect to fraued and error in an audit of financial statements. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. Auditor's responsibility is to express an opinion on financial statements. An audit must be conducted in accordance with the auditing standards generally accepted in India providing reasonable assurance that the financial statements taken as a whole are free from material misstatements whether caused by fraud and error. In forming his opinion on the financial statements the auditor must follow the procedures which is designed to satisfy himself that the financial statements reflect or exibit a true and fair view of the financial position and operating results of the enterprise. Because of the test nature and other inherent limitations of any system of internal control the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error at the time of planning and performing audit procedure and evaluating and reporting the results thereof. So there is a possibility that some material misstatement may remain undiscovered and such risk cannot be avoided completely. The discovery of the material misstatement is not the main objective of audit nor is the auditor's work programme specifically designed to such discovery. But if the auditor has any indication that some fraud or error may have accurred which could lead to material misstatement, the auditor should extend his porcedures to confirm or remove his suspicious. The fact that an audit which is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

C. Social and other specific responsibility :

In forming and expressing an opinion on the financial statements the auditor as a responsible citizen must take into consideration social aspects of audit giving due emphasis on the points that the enterprises are discharging their social responsibilities properly without making any harmful effect on the society it belongs. Like other branches of social science an audit must always have some social objectives.

The audit besides independent financial audit, may encompass such other areas like review of operations, effectiveness of management policies, cost records and so on. Accordingly there will be specific objectives in respect of each type of specific audits.

It is also the objective of an auditing to provide spin-off effects. The auditor sometimes assist his clients to solve various accounting, taxation, financial and other problems.

1.4 Relationship between Accounting and Auditing Principles

Accounting principles are general decision rules derived from the accounting concepts. It influences the development of accounting techniques which are specific rules to record specific transactions and events in an organisation. The end product of every accounting system is the financial statements containing financial information of an entity. In preparing and presenting the financial statements it is essential to consider the following accounting principles :

1. Cost Principle
2. Revenue Principle
3. Matching Principle
4. Objectivity Principle (Verifiability Principle)
5. Consistency Principle
6. Full disclosure Priciple
7. Conservatism Principle
8. Materiality Principle
9. Uniformity and Comparability Principle.

As stated earlier an audit is the independent examination of financial statements of an entity, whether profit oriented or not, and irrespective of its size or legal form, with a view to express an opinion about the true and fairness of the financial information contained therein. An auditor while examining the financial statements have generally assured that all the fundamental accounting principles have been duly complied with in preparation and presentation of the same. So all these accounting principles are equally important to an auditor also and he must have adequate knowledge and clear understanding of it which will facilitate to discharge his professional liabilities properly. The accounting principles, compliance of which is verified in every audit process, may be considered as the basic foundation based on which financial statements are prepared ensuring its reliability, quality, acceptability and usefulness. So there exists a strong interrelationship between accounting and auditing principles.

Moreover as per AAS 1 issued by ICAI on "Basic principles governing an audit" the following are the basic principles of auditing which govern the auditor's professional responsibility and should be complied with whenever an audit is carried out.

1. Integrity
2. Objectivity and independence
3. Confidentiality
4. Skills and competence
5. Planning
6. Documentation
7. Audit evidence
8. Accouting System and Internal Control
9. Work performed by others.
10. Audit conclusion and reporting.

1.4.1 Integrity

Integrity requires that the auditor should be straight forward, honest and sincere in his professional duty. Integrity is subjective and cannot be standarised by making law or by setting standards. While conducting an audit he should maintain an impartial attitude and appear to be free of any interest, so that society do not doubt his integrity.

1.4.2 Objectivity and independence

In the performance of any professional service, the auditor should maintain objectivity and independence.

Objectivity means in reporting and working on any professional work he shall not be influenced by his personal whims and fancies or by other's directions. He should give his opinion based on facts, situation and as per generally accepted auditing principle.

Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him or to his own self-interest.

1.4.3 Confidentiality

The auditor should maintain the confidentiality of information acquired in the course of his work. He should not disclose such information to a third party without specific permission of the client or unless there is a loyal requirement of professional duty to disclose.

1.4.4 Skills and competence

The audit must be performed and the report should be prepared with due professional care by persons who are having adequate training, experience, competence and have attained technical standards. The Institute of Chartered Accountants of India conducts continuing professional education for its members to keep them abreast of recent developments enhancing the quality of auditor.

1.4.5 Planning

The auditor should plan his work covering the following among other theories, which enables him to conduct an effective audit timely and efficiently.

- Acquiring the knowledge of client's business
- Acquiring the knowledge of client's accounting system, policies and internal control procedure
- Determining the degree of reliance of the internal control system and fixing up the extent of checking
- Formulating the audit programme.

1.4.6 Documentation

The auditor should maintain systematically the documents created or collected for various matters during the course of audit. It is important as it provides evidence in future that the audit was carried out in accordance with the basic principles.

1.4.7 Audit Evidence

The auditor should obtain sufficient and appropriate audit evidence by compliance and substantive procedure which enable him to make perfect opinion on the financial statements.

Compliance procedures are tests designed to have reasonable assurance that the internal control system depending on which the audit programme is formulated are in effect.

Substantive procedures are tests of details of transactions, balance and include analysis of significant ratios and trends with a view to obtain evidence as regards completeness, accuracy and validity of the data produced by the accounting system.

1.4.8 Accounting system and internal control

Management is responsible for preparation of financial statements of an entity for which an adequate accounting system should be maintained involving various internal controls commensurate with the size and nature of the business. The auditor must ensure himself that internal control system is adequate providing assurance that all the accounting information which should be recorded has really been recorded. Extent of substantive procedure mainly depends on accounting system and internal control. It becomes less extensive if there is good accounting system and strong internal control system otherwise it will be more extensive.

1.4.9 Work performed by others

In the course of audit the auditor has to delegate work to assistants and also has to consider works performed by other auditors. In all such cases the auditors cannot escape the liability arising out of expression of opinion on the financial statements on the pretex that he delegated the work to others or used the work done by others. He, therefore, should carefully direct, supervise and review the work delegated to others and obtain reasonable assurance that works performed by other auditors and experts is adequate for his perpose.

1.4.10 Audit conclusion and reporting

The end product of every audit process is audit report through which auditor expresses his opinion about the financial statements of an entity.

The auditor's conclusion and reporting should be based on the audit evidence obtained and generally includes as to whether :

(a) The financial statements are prepared on the basis of generally accepted accounting principles and the same is applied consistently.

(b) The financial information complies with relevant laws and regulations.

(c) There is adequate disclosure of all material facts.

The audit report should contain a clear expression of opinion made on the financial information and it must be drawn in conformity with the requirements of the specific statute, agreement or regulation.

The audit report may contain following types of opinion :

(i) unqualified or clean opinion

(ii) qualified opinion

(iii) adverse opinion

(iv) Disclaimer of opinion

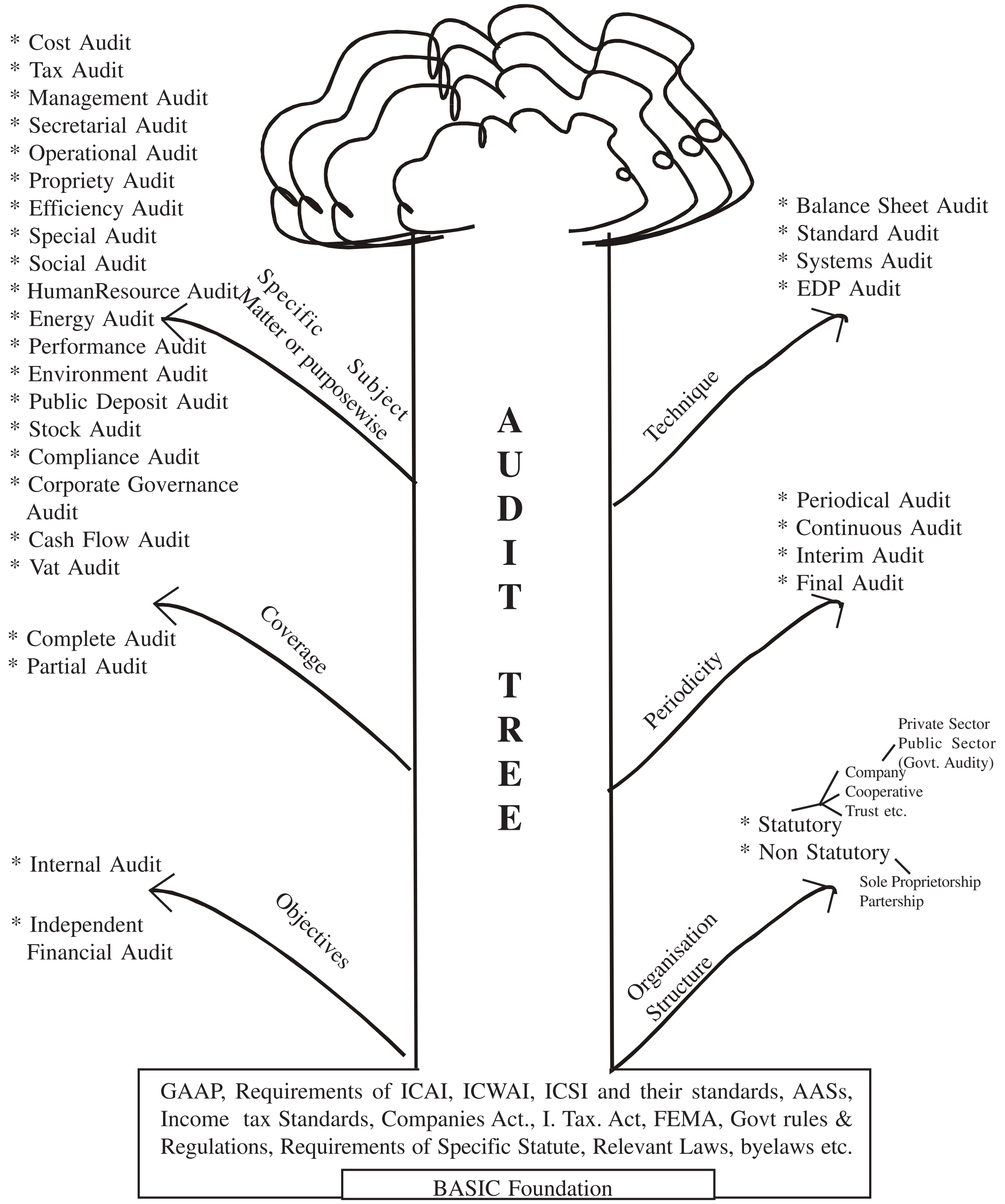
In case of qualified, adverse and disclaimer opinion the audit report should state the reasons for forming such opinion.

1.5 Types of audit

Classification of audit may be done on various basis and on such classification different types of audit are noticed. The total picture about basis and different branches of audit can be shown with the help of a tree may be called as "Audit Tree"

1.5.1 Periodical audit

Periodical audit means an audit which is done at the end of a specific period that may be quarterly, half-yearly or yearly but only after periodic finalisation of accounts. In this case


* Cost Audit
* Tax Audit
* Management Audit
* Secretarial Audit
* Operational Audit
* Propriety Audit
* Efficiency Audit
* Special Audit
* Social Audit
* HumanResource Audit
* Energy Audit
* Performance Audit
* Environment Audit
* Public Deposit Audit
* Stock Audit
* Compliance Audit
* Corporate Governance Audit
* Cash Flow Audit
* Vat Audit
Specific Subject Matter or purposewise
* Complete Audit
* Partial Audit
Coverage
* Internal Audit
* Independent Financial Audit
Objectives
AUDIT TREE
* Balance Sheet Audit
* Standard Audit
* Systems Audit
* EDP Audit
Technique
* Periodical Audit
* Continuous Audit
* Interim Audit
* Final Audit
Periodicity
Private Sector
Public Sector (Govt. Audity)
Company
Cooperative
Trust etc.
* Statutory
* Non Statutory
Sole Proprietorship
Partership
Organisation Structure
GAAP, Requirements of ICAI, ICWAI, ICSI and their standards, AASs, Income tax Standards, Companies Act., I. Tax. Act, FEMA, Govt rules & Regulations, Requirements of Specific Statute, Relevant Laws, byelaws etc.
BASIC Foundation

the audit is commenced and completed in a single uninterrupted session with no chance of any collusion between audit staff and the clients staff and without any dislocation of clients work. Final audit is also known as periodical audit as it refers to a situation where the audit work is commenced only after the expiry of the period to be covered by the audit. Periodical audit is economical and very much convenient and useful for business houses which are small.

1.5.2 Interim audit

An interim audit is that kind of audit which is conducted for a part of the accounting year with some interim purpose. It involves an audit of the financial statements or other data relating to only a part of the accounting year and is generally conducted between two periodical or regular audits. The purpose for which interim audit is conducted may be :

(1) Declaration of interim dividend

(2) Submission of accounts for a specific purpose as required by any authority.

(3) For the disclosure of periodic financial information in compliance with any statutory requirements-

(4) For obtaining assurance as regards adquacy of internal control system in the organisation before starting its final audit.

Advantages :

(i) It facilities timely completion of final audit.

(ii) Error and fraud can be detected more quickly.

(iii) It helps in carrying moral check on the staff of the client.

(iii) It is very much helpful when publication of interim financial information become necessary.

1.5.3 Continuous Audit

According to Spicer and Pegler, ‘‘a continuous audit is one where the auditor’s staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; Such audits are adopted where the work involved is considerable, and have many points in their favour, although they are subject to certain disadvantages.’’

According to R.C. Williams ‘‘a continuous audit is one where the auditor, or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends the clients offices at regular or irregular intervals during the period.’’

A continuous audit, thus, is an audit which involves examination of accounts throughout the year at regular or irregular intervals. It is necessary for big business houses and not for small concerns where accounts can be audited at the close of the financial year when they are ready.

Continuous audit is suitable in the following cases :

(a) where final accounts are desired to be presented just after the close of the financial year, as in the case of a bank.

(b) where the transactions are many in number and it is considered necessary to get them audited at regular intervals.

(c) where the internal check system is not satisfactory.

(d) where after every month or quarter the statement of accounts are prepared and required to be presented to the management.

(e) where sales affected are very high.

Advantages

(1) As the auditor visit his client's office at regular interval a detailed close and exhaustive checking can be possible.

(2) The auditor checks the accounts in a detailed manner at regular intervals. It is thus possible for him to detect errors and fraud, easily and quickly.

(3) Since the accounts are checked round the year. It becomes possible to present the final audited accounts to the shareholders immediately after the end of the financial year. Thus, the work of the auditor becomes more efficient.

(4) Frequent visits by the auditor to the client's office makes the client's staff regular. The accounts they maintain become up-to-date and more accurate.

(5) Sometimes the auditor also pays surprise visits to the client's office which results in a moral check on them as these employees are not aware when the auditor will come. They will have to update their book regularly to avoid harrasment.

(6) The auditor keeps himself in touch with the business affairs and its technical details regularly. It helps him to provide valuable suggestions to his clients for improving the working of the business and the system of maintaining accounts.

(7) In big business houses where monthly statements are prepared continuous audit has proved to be very useful.

Distinction between continuous audit and interim audit—

(1) In the case of continuons audit, the work of audit is carried on for the whole financial year while in the case of interim audit, the audit work is done only up to a certain date involving a part of the financial year.

(2) In the case of continuous audit the preparation of trail balance is not necessary at intervals but in the case of interim audit it is prepared.

(3) Verification of assets and liabilities, in the case of continuous audit, is done at the close of the accounting year while the same is done, in the case of interim audit, at the time of audit.

(4) In the case of continuous audit the auditor submits his audit report at the close of the accounting year whereas in the case of interim audit report is submitted immediately after completion of the audit.

(5) In the case of continuous audit since the auditor's staff remains present in the client's office throughout the year it causes inconvenience to the staff of the client while interim audit does not have such problem.

1.6 Extended meaning of audit

The auditing profession now acknowledges that the public has now come to expect more of the auditor than mechanically drafted reports on financial statements. As a result modern concept of audit goes much beyond the statutory requirements to include audits like Environment Audit, Human Resource Audit, Social Audit, Energy Audit etc. in its perview.

1.7 Philosophy of audit

The services provided by an auditor may not be directly needed for the day to day operation of the business but he is concerned with appraisal, interpretation, analysis and valuation. It should not be assumed that he is a professional appraiser, analyst or valuer. However, the auditor is statutorily and / or morally responsible to protect and look into the interest of various parties who are directly or indirectly associated with the entity and interested in knowing the financial information with respect to that. He, therefore, has to appraise and certify the accuracy of various statements as well as to examine the financial statements with a view to express an opinion thereon in respect of its true and fairness keeping in view the requirements of law and generally accepted accounting principles. Modern concept of audit goes much beyond the statutory requirements. The modern auditor must be a talented individual who has the ability to make vital decisions on many important issues, and the courage and depth of character of stand by personal convictions. The auditing function offers individuals an opportunity that is rare in other fields of endeavor—that is, the opportunity, on almost a daily basis, to be responsible for making decisions and judgements as to what is right and what is wrong, and to stand by these decisionas and judgements regardless of the pressures that may be brought to bear. This opportunity has attracted many outstanding individuals to the field of auditing and has helped to retain them.

1.8 Auditing as a Social Science

Any branch or class of knowledge which directly of indirectly provides services to the society is called social science. All classes of knowledge are, in fact, social science. Accounting and auditing plays a vital role in ensuring steady economic growth of a country. Adequate and globally accepted accounting system and control through standard auditing practices helps a country in achieving his expected economic growth. It is important both at micro and macro level. And, because of its social implication and importance, it is influenced by law and governmental action. Introduction of companies Act and its amendment from time to time more specifically the sections 233A, 233B, 227 (1A) and 227 (4A) of the Companies Act may be cited as the glaring examples of government action on accounts and audit keeping in view the needs, benefits of the society. With globalisatioin the society's expectation from the profession of accountancy and auditing has also increased remarkably. Thus accounting and auditing may be considered as a social science.

1.9 Social Objects of Audit

The accountancy profession has to play an important role in the society. A distinguishing mark of this profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community and others who rely on the objectivity intergrity, and independence of professional accountants to maintain the orderly functioning of commerce. The reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves. Professional accountants hold important position and get highest status because they provide continuously the public with unique professional services at a level which demonstrates that the public confidence is firmly founded.

1.10 Questions

1. Define an audit and state its objectives.
2. Describe the basic principles of auditing.
3. State the relationship between accounting and auditing principles.
4. How do you classify an audit.
5. Distinguish between continuous and interim audit.
6. Write short notes on the following :
   (a) Social objects of audit
   (b) Philosophy of audit.
7. ''Auditing is a social science''—comment.