INTRODUCTION TO AUDITING LECTURE 01

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Origin of Audit

The term audit is derived from the Latin term 'audire,' which means to hear.

In old days whenever proprietors suspected a fraud or error, certain people were appointed to hear verbal evidence of transaction. (in barter system)

Meaning of Audit

- an official inspection of an organization's accounts, typically by an independent body.

"audits can't be expected to detect every fraud"

- conduct an official financial inspection of (a company or its accounts).

Definition

- An unbiased examination and evaluation of the financial statements of an organization. It can be done internally (by employees of the organization) or externally (by an outside firm).

Definition of Audit

- **Auditing** refers to a systematic examination of books, accounts, documents and vouchers of an organization to ascertain how far the financial statements present a true and fair view of the concern.

- Spicer and Pegler:
- "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

Definition

- Prof. L.R.Dicksee.

"auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate."

Definition

- ISA (International Standard of Auditing)

“ An Audit is the independent examination of financial statement or related information of an 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”

FEATURES OF AUDITING

a. Audit is a systematic and scientific examination of the books of accounts of a business;

b. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.

c. Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

d. Audit is a critical review of the system of accounting and internal control.

Features of Auditing.

e. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.
f. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.
g. The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

Differences Between Auditing And Accounting

- Accounting is related to the collection, recording, analysis and interpretation of financial transactions but auditing refers to the examination of books of accounts along with the evidential documents. So, following differences can be shown between auditing and accounting:

1. Meaning

- Accounting is the act of collecting, recording, analyzing and interpretation of financial transactions but auditing is the act of examination of books of accounts and evidential documents, so as to prove the true and fair view of profitability and financial position.

2. Beginning Of Work

- Work of accounting begins when financial transactions take place but work of auditing begins when work of accounting ends.

3. Scope

- Accounting prepares profit and loss account and balance sheet and other statements as per the instruction of auditor but auditor checks the books of accounts considering their fairness as well as complying with the provision of company act or not.

4. Nature Of Work

- Accounting keeps the record of financial transactions but auditor checks and verifies the books of accounts.

5. Staff

- An accountant is a staff of an organization and draws the salary from the business but an auditor is an independent person who is appointed for specific period and gets a sum of remuneration.

6. Preparation Of Report

- An accountant does not prepare report after the completion of his task but he has to give information to the management when needed but auditor needs to prepare and present report after the completion of his work to the concerned authority.

7. Responsibility

- An accountant remains responsible to the management but an auditor is responsible to the owners or shareholders.

Accounting vs Auditing

Accounting	**Auditing**
1. It's a continuous process carried out throughout the year.	1.It's a one time activity after the closure of accounting year.
1. No prescribed qualification is required to be an accountant.	2. He must be the member of Institute of Chartered Accountants of Pakistan to become an auditor.
1. An accountant is a employee of the company.	3. An auditor is an independent professional.
1. An accountant gets regular salary for his work.	4. He gets remuneration for his professional work. Audit fees.
1. Accounting is concerned with recording of business transactions systematically. **2. Accounting precedes, auditing.**	5. Its concerned with verification of accounts prepared by the accountant. 6. Auditing succeeds accounting.

Qualities required in an Auditor

- **Professionally Competent :-**
  It is a basic quality of an auditor. He must have a complete and thorough knowledge of the accountancy. To understand the accounting details he can apply his knowledge and skill. It is only possible if he has a sound background in accountancy and he is professionally competent.

  2. Honest :-
  It is also very important quality of an auditor. Justice Hindley says "An auditor must be honest. He must not certify what he does not believe to be true and he must take a reasonable care and skill before he believes that what he certifies is true.

  3. Auditing :-
  An auditor's knowledge of auditing must be upto date. He must know the techniques of auditing. He must have the knowledge of other subjects relating to auditing.

  4. Accounting Knowledge :-
  The auditor should be at home in all the management accounting cost accounting and general accounting.

Qualities required in an Auditor

5. Knowledge Of Business Law :-
An auditor must possess a considerable knowledge of business law. He must be aware about his duties and rights given by law.

6. Knowledge Of Taxation Law :-
Various types taxes are imposed by the government on the business. For example in some countries Income tax, sales tax, gift tax is imposed. So if auditor has not a considerable knowledge about the taxation. He can not perform his services properly.

7. Computer Expert :-
The auditor must be able to operate the computer. Today the business organizations are using computers. If auditor does not know to use computer, he cannot work efficiently.

8. Knowledge Of management System :-
The auditor must have the knowledge of management information system. It helps him to understand the internal set up of the business concern and its operation.

9. Preparation Of Budget :-
The auditor must know that how the organization prepares the budget. If he does not know then it will be not possible for him to audit the various heads of the budget.

10. Intelligent :-
It is also important quality of an auditor that he should be intelligent. He must be able to understand the technical details of any business.

Qualities required in an Auditor

11. Qualification :-
For a professional auditor it is necessary that he should be charted accountant. According to companies ordinance it is essential qualification for auditor.

12. Tactful :-
In a particular situation auditor should deal tactfully. He should ask the questions in such a manner that it does not show about his ignorance or weakness.

13. Maintain Secrecy :-
The auditors nature of work is confidential. He should maintain secrecy from others about the affairs of his client.

14. Patience :-
There should be a quality of patience in the auditor. Before signing on any paper he should check the evidence and then sign it. He never checks the papers in hurry.

15. Critical Attitude :-
It is also very essential quality of the auditor. He should examine the statements critically. He should ask the various questions from the client and try to find contradictions.

Qualities required in an Auditor

16. Bold And Courageous :-
Auditor should be bold and courageous person. He should not be influenced by any authority. He should possess the courage to face the difference of opinion between him and client on any issue.

17. Courteous :-
It is an important quality which the auditor should possess. His attitude towards the staff of client should be very humble and polite. He should also stress on his own staff to be courteous with the client.

18. Independent :-
The auditor should be impartial. He should not have such relations with the organization which may affect his independence. He should give his opinion independently.

19. Common Sense :-
The auditor must have the quality of common sense and judgement. He may be able to assess the value of depreciation and bad debts.

Scope of Audit.

- The scope of audit is increasing with the increase in the complexities of the business. It is said that long range objectives of an audit should be to serve as a guide to the management future decisions.

- Today most of the economic activities are largely conducted through public finance. The auditor has to see whether these larger funds are properly used. The scope of audit encompasses verification of accounts with a intention of giving opinion on its reliability. Hence it covers cost audit, management audit, social audit etc. It should be remembered that an auditor just expressed his opinion on the authenticity of the account. He has no power to take action against anybody, in this regard its said that "an auditor is a watch dog but not a blood hound".

Objectives of Auditing.

- Auditors are basically concerned with verifying whether the account exhibit true and fair view of the business. The objectives of auditing depends upon the purpose of his appointment.

- **Primary Objective**.
- The primary objective of an auditor is to respect to the owners of his business expressing his opinion whether account exhibits true and fair view of the state of affairs of the business. It should be remembered that in case of a company, he reports to the shareholders who are the owners of the company and not tot the director. The auditor is also concerned with verifying how far the accounting system is successful in correctly recording transactions. He had to see whether accounts are prepared in accordance with recognized accounting policies and practices and as per statutory requirements.
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- **Secondary Objective:**
- The following objectives are incidental to the main objective of audting.
- **Detection and prevention of errors:** errors are mistakes committed unintentionally because of ignorance, carelessness. Errors are of many types:
  - **Errors of Omission:** These are the errors which arise on account of transaction into being recorded in the books of accounts either wholly partially. If a transaction has been totally omitted it will not affect trial balance and hence it is more difficult to detect. On the other hand if a transaction is partially recorded, the trial balance will not agree and hence it can be easily detected.
  - **Errors of Commission:** When incorrect entries are made in the books of accounts either wholly, partially such errors are known as errors of commission. Eg: wrong entries, wrong Calculations, postings, carry forwards etc such errors can be located while verifying.
  - **Compensating Errors:** when two/more mistakes are committed which counter balances each other. Such an error is know an Compensating Error. Eg: if the amount is wrongly debited by Rs 100 less and Wrongly Credited by Rs 100 such a mistake is known as compensating error.
  - **Error of Principle:** These are the errors committed by not properly following the accounting principles. These arise mainly due to the lack of knowledge of accounting. Eg: Revenue expenditure may be treated as Capital Expenditure.
  - **Clerical Errors;** A clerical error is one which arises on account of ignorance, carelessness, negligence etc.

Location of Errors:

- It is not the duty of the auditor to identify the errors but in the process of verifying accounts, he may discover the errors in the accounts. The auditor should follow the following procedure in this regard.
  - Check the trial balance.
- Compare list of debtors and creditors with the trial balance.
- Compare the names of account appearing in the ledger with the names of accounting in the trial balance.
- Check the totals and balances of all accounts and see that they have been properly shown in the trial balance.
- Check the posting of entries from various books into ledger.

Deduction and Prevention of Fraud:

- A fraud is an Error committed intentionally to deceive/ to mislead/ to conceal the truth/ the material fact. Frauds may be of 3 types.
  - **Misappropriation of Cash:** This is one of the majored frauds in any organisation it normally occurs in the cash department. This kind of fraud is either by showing more payments/ less receipt.
- The cashier may show more expenses than what is actually incurred and misuse the extra cash. Eg: showing wages to dummy workers. Cash can also be misappropriated by showing less receipts
- Eg: not recording cash sales. Not allowing discounts to customers. The cashier may also misappropriate the cash when it is received. Cash received from 1st customer is misused when the 2nd customer pays it is transferred to the 1st customer's account. When the 3rd customer pays it goes forever. Such a fraud is known as "Teaming and Lading". To prevent such frauds the auditor must check in detail all books and documents, vouchers, invoices etc.
  - **Misappropriation of Goods:** here records may be made for the goods not purchase not issued to production department, goods may be used for personal purpose. Such a fraud can be deducted by checking stock records and physical verification of goods.
  - **Manipulation of Accounts:** this is finalizing accounts with the intention of misleading others. This is also known as "WINDOWS DRESSING". It is very difficult to locate because its usually committed by higher level management such as directors. The objective of WD may be to evade tax, to borrow money from bank, to increase the share price etc.
- to conclude it cab be said that, it is not the main objective of the auditor to discover frauds and irregularities. He is not an insurance against frauds and errors. But if he finds anything of a suspicious nature, he should probel it to the full.

ADVANTAGES OF AUDIT:

- Audited account are detected as an authentic record of transaction.
- Errors and frauds are detected and rectified.
- It increases the morale of the staff and thus it prevents frauds and errors.
- Because of his expertise the auditor may advise on various matters to his clients.
- An auditor acts as a trustee of his shareholders. Hence he safeguards their financial interest.
- For taxation purpose auditing of account is amust.
- In case of any claim is to be made from the insurance company only audited account should be submitted.
- Even in case of partnership firm auditing of accounts helps in the settlement of claim at the time of retirement/death of a partner.
- Auditor account helps in managerial decisions.
- They are useful to secure loan at the of amalgamation, absorption, reconstruction etc.
- Auditing safeguards the interest of owners, creditors, investors, and workers.
- It is useful to take certain financial decisions like issuing of shares, payment of dividend etc.

TYPES OF AUDIT:

- **Statutory Audit:** any audit carried on as per the requirement of law is called as a statutory audit. eg: all companies have to get their accounts audited as per the provision of the company's Act of 1956.
- **Periodical/ Annual Audit:** it is a kind of audit where the auditor verifies the account at the end of the financial year. He starts the audit work after the closure of financial year. This is a common audit and is mostly used by small organizations.
- **Interium audit:** its an audit conducted in the middle of the accounting year before the accounts are closed. In other words any audit conducted between two financial audit is known s interium audit. The objective is to get periodical results, to declare interium dividend.
- **Partial Audit:** when an auditor is asked to audit only a part of the account system. Its called partial audit. Eg: he may be asked to audit only the payment side of cash book.
- **Balance sheet audit:** it's a kind of partial audit and is concerned with the verification of only those items appearing in the Balance Sheet. It is more popular in the USA. Infact while verifying BS items the auditor verifies/ checks all related items/accounts.
- **Cost audit:** cost audit is defined as the verification of cost accounting records. Data and techniques for its accuracy and authenticity. It gets as effective managerial tool for the detection of errors and frauds in cost accounting records. The companies act implies the central government to order cost audit incase of specifies companies.
- **Management audit:** Management audit may be defined as a comprehensive examination of an organizational structure of a company, institution/government and its plans and objectives it means of operations and use of human and physical facilities. The main objective of mgt audit is to see how far the objectives of mgt are fulfilled. It aims to ascertain whether sound mgt prevails throughout the organisation and evaluates its efficiency in the system of its operation.
- **Continuous audit:** a continuous audit is one in which the auditor visits his clients office at regular intervals through out the year to verify the account. The objective of CA may be-
  - To get final account audited immediately after the closure of accounting year.
  - When the business is very large.
  - When interval control system is into effective.
  - When regular final accounts are required.

- **<u>ADVANTAGES:</u>**
  - Errors and frauds are discovered and rectified quickly.
  - The chances of fraud are reduced.
  - The workers will be careful in their work.
  - Continuous audit acts as a valuable morale check on the staff.
  - Final audit becomes easier and faster.
  - If the company wants to declare interium dividend its easier to prepare interium account.
  - It increases the efficiency and accuracy in the accounts.
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- **<u>DISADVANTAGES</u>:**
- After the auditor's visit is over, alternative may be made.
- It affects the regular work.
- Its not suitable for small organizations.
- The auditor may loose the line of work if he does not complete his work in a visit.