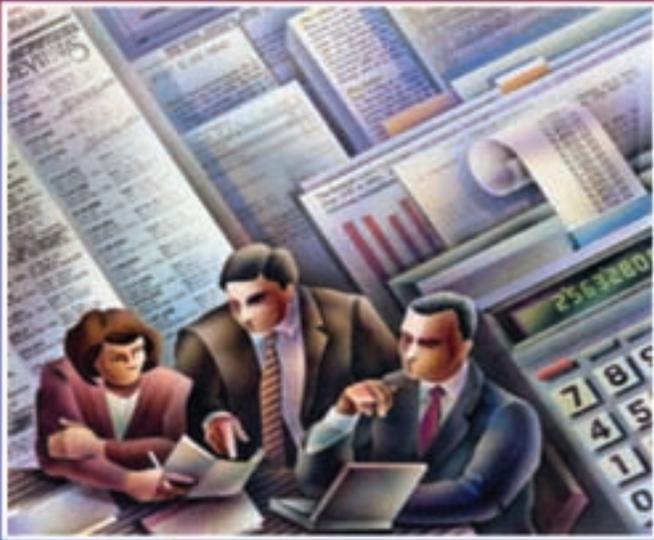


VAYU EDUCATION OF INDIA



AUDITING



SANDHYA SINGH

AUDITING

Sandhya Singh

MBA (HR & FINANCE), B.Sc(CS), Ph.D Pursuing
Assist. Professor

Shriji Govardhan Maharaj,
College of Management, Govardhan, Mathura.



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Ph.: 91-11-43526600, 41564445

Fax: 91-11-41564440

E-mail: vayueducation@rediffmail.com, vayueducation1@gmail.com

Web: www.veiindia.com

PREFACE

I am glad to present this book especially designed to serve the needs of the students. The book has been written keeping in mind the general weakness in understanding the fundamental concepts of the topics. The book is self-answer pattern. The language of book is quite easy and understandable based on scientific approach. Any further improvement in the contents of the book by making corrections, omission and inclusion is keen to be achieved based on suggestions from the readers for which the author shall be obliged.

I acknowledge special thanks to My Big Brother Mr Bhanu Pratapsingh Solanki, who are the backbones and main concept provider and also have been constant source of motivation throughout this Endeavour. They played an active role in coordinating the various stages of this Endeavour and spearheaded the publishing work. I look forward to receiving valuable suggestions from professors of various educational institutions, other faculty members and students for improvement of the quality of the book. The reader may feel free to send in their comments and suggestions to the under mentioned address.

– Author

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About the Book

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors. If decisions are to be consistent with the intention of the decision-makers, the information used in the decision process must be reliable.

Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the borrower makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions. As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

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.

ABOUT THE AUTHOR

Sandhya Singh MBA (HR & FINANCE), B.Sc (CS), is working as Assist. Prof. in Shriji Govardhan Maharaj, College of Management, Govardhan, Mathura. Before this I have worked with Venkateshwara group of institution, Meerut. She has been teaching different subjects of management from 2009 (last 5 years) in renowned colleges of UPTU, MTU.

She has authored many books like, Managerial Economics, Industrial Law, Manufacturing, Maintenance and Waste Management, Production Management, Research Methodology, Operation Research, Industrial Management, Construction Management etc.

She has presented and published good number of research papers in national and international seminars and conference and journals.

UNIT 1

INTRODUCTION

1.1 INTRODUCTION-AN OVERVIEW OF AUDITING

Economic decision in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

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A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons.

1.2 ORIGIN AND EVOLUTION

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them. Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances.

The original objective of auditing was to detect and prevent errors and fraud. Auditing evolved and grew rapidly after the industrial revolution in the 18th century. With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees. The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

1.3 DEFINITIONS OF AUDIT

It is a bit difficult to give a precise definition of word audit in a word or two. Originally its meaning and use was confined merely to cash audit and the auditor had to ascertain whether the person responsible for the maintenance of accounts had properly accounted for all the cash receipts the payment on behalf of his principle. But the word, audit, had a wide usage and it now means a through scrutiny of the books of accounts and its ultimate aim is to verify the financial position position disclosed by the balance sheet and the profit and loss account of a company. The following are the some of the definitions of audit given by some writers:

Spicier and Pegler

An audit is such an examination of the books, accounts and vouchers of a business as it enable the auditor to satisfy that the Balance Sheets is properly drawn up, so as to give a true and fair view of the state of the affairs of the business and whether the profit and loss accounts gives a true and fair view of the profit or 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 respects he is not satisfied.

Montgomery

Auditing is a systematic examination of the books and records of a business or other organization, in order to ascertain or verify and report upon the facts regarding its financial operation and the result thereof.

Lawrence, R. Dicksee

An audit is an examination of records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some circumstances it may be necessary to ascertain whether the transactions are supported by authority.

F.R.M De Paula

An audit denotes the examination of Balance sheet and profit and loss accounts prepared by others together with the books, accounts and vouchers relating there to in such a manner that the auditor may be able to satisfy himself and honestly report that in his opinion, such Balance sheet is properly drawn up so as to exhibit a true and correct views of the state of affairs of the particular concern according to the information and explanations given to him and as shown by the books of acconts.

A. W. Hanson

An audit is an examination of such records to establish their reliability and the reliability of statement drawn from them.

R. B. Bose

Audit may be said to the verification of the accuracy and correctness of the books of accounts by independent person qualified for the job and not in any way connected with the preparation of such accounts.

Taylor and Perry

An audit is an investigation by an auditor into the evidence from which the final Revenue Accounts and Balance sheet or other statement of an organization have been prepared, in order to ascertain that they present a true and fair view of the summarized transactions for the period under review and of the financial state of the organization at the ending-date, so enabling the auditor to report thereon.

1.4 BASIC PRINCIPLES OF AUDIT

AAS-1 describes the basic principles, which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. These are:—

1. Integrity, objectivity and independence

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever it's actual effect, as being incompatible with integrity and objectivity.

2. Confidentiality

The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is legal or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.

3. Skill and competence

The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others

When the auditor delegates work to assistant or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise and review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.

5. Documentation

The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning

The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.

7. Audit evidence

The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.

8. Accounting system and internal control

The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

9. Audit conclusions and reporting

The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

1.5 AUDIT TYPES MEANING

Audit is not legally obligatory for all types of business organizations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits:

- (i) **Audit required under law:** The organizations which require audit under law are the following:
 - (a) companies governed by the Companies Act, 1956;
 - (b) banking companies governed by the Banking Regulation Act, 1949;

- (c) electricity supply companies governed by the Electricity supply Act, 1948;
 - (d) co-operative societies registered under the co-operative Societies Act, 1912;
 - (e) public and charitable trusts registered under various Religious and Endowment Acts;
 - (f) corporations set up under an Act of parliament or State Legislature such as the Life Insurance Corporation of India.
 - (g) Specified entities under various sections of the Income-tax Act, 1961.
- (ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. in respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purpose like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special feature which will be seen later.

1.6 FEATURES OF AUDITING

- (a) Audit is a systematic and scientific examination of the books of accounts of a business;
- (b) Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
- (c) Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.
- (d) Audit is a critical review of the system of accounting and internal control.
- (e) Audit is done with the help of vouchers, documents, information and explanations re-ceived from the authorities

1.7 PURPOSE

The main purpose of Auditing or object is to find the opinion of an auditor about the correctness and reliability of accounts and the financial position of the business concern. For this purpose auditor has to check the arithmetical accuracy of the books of account and to find out that whether the transactions entered in the books of account are correct or incorrect. This is done by various methods like inspecting comparing and checking. So all that work that is done by the auditor ensures him that figures are facts.

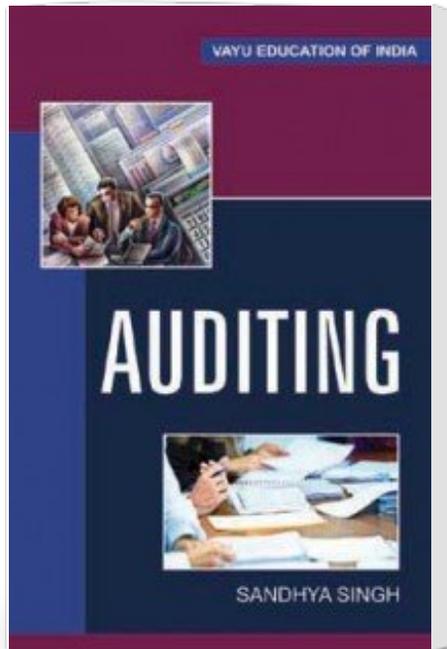
Main Objectives of Auditing

1. **Reporting:** The objective of an audit of financial statement is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects in accordance with an identified financial reporting

frame work. The phrases used to express the auditor's opinion are given a true and fair view or present fair in all material respects, which are equivalent terms.

2. **Purpose of audit:** The purpose of audit is to check the proper accounting to policies. For the better accounting system it is necessary to follow the accounting policies. Only by this way we can get the effective result. The auditor's purpose is to check that accounting policy has been followed or not.
3. **prescribed law:** Another objective of the auditor is to check that the accountant has used the prescribed law. There are so many laws related to working of business. The auditor can indicate whether the proper law has been applied or not.
4. **Opinion:** The purpose of the audit is to get the correct opinion about the business so for this the auditor should be honest, confident and he must have the ethical standard for his work.
5. **True and Fare view:** The purpose of the auditing is to determine the correctness of statement. After auditing the financial statement has the correct and true view about the business.
6. **Prevention of Errors:** The audit is committed for the prevention of errors. These errors can be prevented through internal check also.
7. **Detection of Errors:** Another purpose of audit is to detect the errors. The auditor uses different ways and means to find your errors.
8. **Prevention of Fraud:** The prevention of fraud is another purpose of auditing. It consists of the omission of the effect of transaction, recording or transaction without substance etc.
9. **Detection of Fraud:** The detection of fraud is also the purpose of the audit. It is the responsibility of the management to detect to Fraud.
10. **Cost Audit:** To verify the correctness of cost accounting is the main purpose of the cost audit. The management had a duty to follow the cost objectives in maintaining the records of business transaction.
11. **Property-Audit:** The examination of the proper use of money is the main purpose of the property audit. How and where the money of business is used must be mentioned in this audit.
12. **Management-Audit:** The management audit refers to the audit of the management structure either these are according to the requirements of the business or not. It is a voluntary audit.
13. **Tax-Audit:** Tax audit is conducted to satisfy the income tax officer. This type of audit is conducted to determine the income. Usually the partnership and the sole proprietorship conduct this type of business.
14. **Social-Audit:** The measurement of social performance of the business is the main object of social audit.

Auditing By Sandhya Singh



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