# UNIT 1 BASIC CONCEPTS

## Structure



## 1.0 OBJECTIVES

After studying this unit, you should be able to :

- explain the concept of auditing
- enumerate the objectives of audit
- describe different classes of audit
- analyse various modes of conducting audit
- explain the qualities of an auditor.

## 1.1 INTRODUCTION

With the advent of large scale production verification and examination of accounting became inevitable. Auditing is the systematic and scientific examination of the books of accounts are records of a business. In this unit you will learn the concept of auditing and different classes of audit. You will also learn various modes of audit and qualities of an auditor.

## 1.2 CONCEPT OF AUDITING

The practice of auditing the accounts of public institutions existed as early as the times of ancient Egyptians, the Greeks and Romans. In those days checking clerks were appointed to scrutinise the accounts of public institutions. The main purpose of auditing during those days was to ascertain whether the persons responsible for, maintaining accounts had properly accounted for all receipts and payments or not, and to locate frauds.

### 1.2.1 Origin of Auditing

Audit, as it exists today, is the result of Industrial Revolution in 18th century, which brought in its wake large scale production, steam power, improved banking facilities and

better means of transport and communication. The Revolution also resulted in the increase of trading and industrial operations which required huge amounts of capital. It was not possible for small entrepreneurs to meet the requirements of increased capital due to their limited resources. This gave birth to joint stock form of organisation. Under this form of organisation, the shareholders contribute capital and have no control over the day-to-day working of the organisation. The shareholders who have invested their money would naturally be interested to know the financial position of the organisation. As such, the need arose for appointing an independent person who would check the accounts and report to the shareholders on the accuracy of the accounts and the safety of their investment.

The system of accounting and auditing of state revenue and expenditure is believed to have existed in India under Maurya and Hindu Kings. Kautilya in his **Arthashastra** had given details regarding accounting and auditing of state finances. According to him, "all undertakings depend on finance. Hence, foremost attention shall be paid to the treasury." He had also mentioned various frauds and embezzlements and prescribed punishments for the same.

The growth of accounting profession in India is of recent origin. For the first time, Indian Companies Act, 1913 prescribed the qualifications of an auditor and also mentioned his powers and duties and the procedure of appointment. According to this Act, the audit of Joint Stock Company was made compulsory. The diplomas and certificates were issued by the Central and State Governments to those who had undergone the prescribed an Indian Accountancy Board to advise on matters relating to professional accounting. In the year 1949, the Chartered Accountants Act was passed according to which the affairs of the profession were passed on to the profession itself i.e., Institute of Chartered Accountants of India. Further, the Companies Act, 1956 elaborated the provisions relating to the accounts and audit of Companies. Now, a person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949.

### 1.2.2 Definition of Auditing

The word 'audit' is derived from the Latin word 'audire' which means 'to hear'. In the olden days whenever the proprietors of a business concern suspected fraud, they appointed a person to check the accounts and to hear the explanations given by the persons responsible for keeping the accounts. The audit during those days was interested in ascertaining whether the persons responsible for maintaining amounts had properly accounted for all receipts and payments to his principal and to locate frauds and errors. It was merely a cash audit. However, the object of the modern audit is not confined to cash verification but to report on financial position of the undertaking as disclosed by its Balance Sheet and the Profit and Loss Account.

It is very difficult to give a precise definition of the term 'auditing'. Some of the definitions given by different writers are as follows :

According to Montgomery, a celebrated author, "*auditing is a systematic examination of the books and records of a business or the organisation in order to ascertain or verify and to report upon the facts regarding the financial operation and the result thereof.*"

The above definition has been expanded further by Spicer and Pegler as follows :

"*An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy 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 whether the Profit or Loss for the financial period according to the best of his information and the explanations given to him and as shown by the books, and if not, in what respect he is not satisfied.*"

According to Lawrence R. Dicksee, "*an audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances, it may be necessary to ascertain whether the transactions themselves are supported by authority.*"

R.K. Mautz defines auditing as being "*concerned with the verification of accounting data, with determining the accuracy and reliability accounting statement and reports.*"





From the above definitions, it is clear that *auditing is the systematic and scientific examination of the books of a accounts and records of a business so as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.* In order to report on the financial health of the business, the auditor will have to go through various books of accounts and related evidence (external and internal) to satisfy himself about their accuracy and authenticity.

### 1.2.3 Difference between Accountancy and Auditing

1 Accountancy is mainly concerned with the checking of the transactions recorded in the books of accounts, extraction of the trial balance, preparation of the trading, profit and loss account and balance sheet. Auditing is the critical examination of the books of accounts and checking of the financial statement for the purpose of ascertaining the true and fair position and results of operation of a concern. Audit does not involve the preparation of accounts but it is concerned with the detailed examination of the complete accounting records.

2 Some times, auditor is called upon to write up the books of accounts, extract an agreed trial balance and prepare Profit and Loss Account and Balance Sheet. If he does that, he would be doing the work of an **accountant** and not that of an **auditor.** Thus, the preparation of the accounts is not part of an audit. As an auditor he is required to report, to his appointing authority, that the Profit and Loss Account and the Balance Sheet have been properly drawn up and reveal the 'true and fair view' of the state of affairs and results of operation of the concern.

3 An auditor starts his work only after the job of an accountant is completed. In other words, there cannot be auditing without the prior existence of accounts.

### 1.2.4 Difference between Auditing and Investigation

1 Investigation is the examination of accounts for a special purpose. The purpose may be to find out the financial position of the borrowing concern or the earning capacity of the concern, etc., whereas audit is carried out to ascertain whether or not the Profit and Loss Account and the Balance Sheet exhibit a true and fair view of the state of affairs and results of operation of the undertaking.

2 An audit is performed on behalf of the owners of the organisation whereas the investigation may be carried out on behalf of an outsider who intends to join the business as a partner or on behalf of the proprietors when they suspect fraud in their business.

3 An audit relates to 6 months or one year period but investigation may concern 2, 3, and 4 years etc.

4 Investigation is not compulsory whereas Audit is compulsory in case of Joint Stock Company.

5 The programme of work investigation depends upon the purpose of an investigation. It is not confined to the examination of accounts but enquiry into the relevant matters also. But auditing is concerned with the critical examination of the accounting records and report on the financial state of affairs and results of operation of a concern for a particular financial year.

**Check Your Progress A**

1 Define Auditing.

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2 Distinguish between accountancy and auditing.

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3 State whether the following statements are True or False.

i) Auditing of accounts is compulsory in a partnership firm.

ii) Auditing of accounts is undertaken to detect frauds in the books of accounts.

iii) A professional auditor cannot take up the work of preparing the accounts of a company.

iv) Investigation is taken up only behalf of the owner of the entity.

v) Investigation of accounts is not compulsory but audit of accounts is, in case of accountant.

vi) Accounts of an individual concern should be audited by the qualified professional accountant.

vii) In ancient period the audit was confined to cash audit and not to locate frauds.

viii) Audit of company accounts is compulsory under the Institute of Chartered Accountants Act of 1949.

## 1.3 OBJECTIVES AND ADVANTAGES OF AUDIT

The objectives of an audit may broadly be classified as (1) Primary objectives and (2) Secondary objectives. Let us discuss them in details.

### 1.3.1 Primary Objectives

The main purpose of audit is to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period. The Companies Act, 1956 requires that the auditor of a Company has to state whether in his opinion the accounts disclose a **'true and fair view'** of the state of company's affairs, profit and Loss Account and Balance Sheet of the state of affairs of a business, the auditor carries out a process of examination and verification of books of accounts and relevant documents. Such an examination will enable the auditor to report to his client on the financial condition and working results of the organisation. While carrying out the examination of the various books of accounts, relevant documents and evidences, the auditor may come across certain errors and frauds. Despite such a possibility the detecting of errors and frauds is an incidental object. However, laymen have always associated the detection of errors and frauds as the main function of an auditor which is not true.

At the same time audit also discloses how far the accounting system adopted in the organisation is adequate and appropriate in recording the various transactions as well as the weaknesses of these systems.

### 1.3.2 Secondary Objectives

As stated above, an auditor has to examine the books of accounts and the relevant documents in order to report on the financial condition of the business. In the process of such an investigation of accounts certain errors and frauds may be detected. These are discussed under the following two heads:





**Detection and Prevention of Errors :** Errors are of various types which are discussed below:

1 **Clerical Errors :** Such an error arises on account of wrong posting. For example, an amount received form R is credited to S. Though there is wrong posting still the trial balance will agree. Clerical errors are of three types as follows:

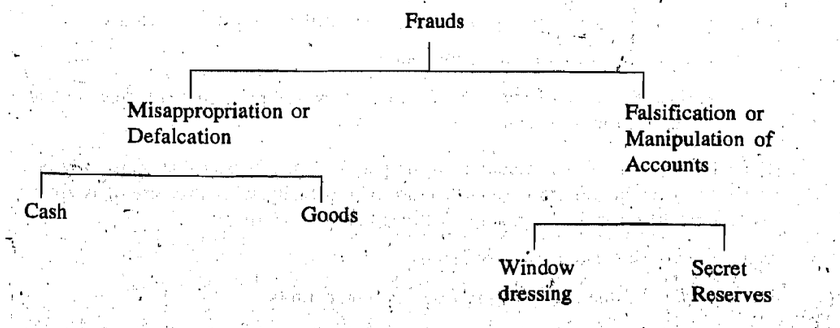
a) **Errors of Commission :** These errors are caused due to wrong posting either wholly or partially of the amount in the books of original entry or ledger accounts or wrong calculations, wrong totalling, wrong balancing, and wrong casting of subsidiary books. For example, Rs. 2000 is paid to a supplier and the same is recorded in the cash book. While posting to the ledger, the supplier's account is debited by Rs. 200. It may be due to carelessness of the clerk. Most of the errors of commission are reflected in the trial balance and these can be discovered by routine checking of the books.

b) **Errors of Omission :** Such errors arise when the transactions are not recorded in the books of original entry or posted to the ledger. For example, sales are not recorded in the sales book or omission to enter invoices in the purchase book. For example, Rs. 5,000 is paid to a supplier. The entry in the cash book is made on the credit side but posting to the supplier side is omitted. Errors due to entire omission will not affect the trial balance whereas error due to partial omission will affect the trial balance and can be detected.

c) **Compensating Errors :** When two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are referred to as compensating errors. For example, A's account which was to be debited for Rs. 200 was credited for Rs. 200 and similarly, B's account which was to be credited for Rs. 200 was debited for Rs. 200. These two mistakes will nullify the effect of each other. Both the sides of the trial balance are equally affected. As such, these errors are difficult to locate unless detailed investigation is undertaken.

2 **Errors of Principle :** Such errors are committed when some fundamental principle of accounting is not properly observed in recording a transaction. For example, if there is incorrect allocation of expenditure or receipt between capital and revenue or when closing stock is over-valued. Though trial balance will not disagree, the Profit and Loss Account may be very much affected. Sometimes, such errors are committed deliberately to falsify the accounts or unintentionally due to lack of knowledge of sound principles of accounting. Thus, a thorough examination is to be done to locate such errors.

**Detection and Prevention of Frauds :** Frauds are always committed deliberately and intentionally to defraud the proprietors of the organisation. If the frauds remain undetected, they may affect the opinion of the auditor on the financial condition and the working results of the organisation. It is, therefore, necessary that the auditor should exercise utmost care to detect such frauds. Frauds may be of the following types:




As it is clear from the above chart that frauds may be classified into misappropriation and falsification. Let us discuss them in detail.

1 **Misappropriation of cash :** Misappropriation or defalcation of cash is very common specially in a big business firm, since the owner has very little control over the receipts and payments of cash, since the owner has very little control over the receipts and payments of cash. Cash may be misappropriated by various ways as follows :

i) Suppressing receipts

ii) recording less amount than the actual amount of receipt

iii) Recording fictitious payments

iv) Recording more amount than the actual amount of payment.

In order to discover such misappropriation of cash, the auditor should check the Cash Book with original records, counterfoils or receipt book, bills register, salesmen's diary, invoices, wage sheets, vouchers, etc. There should be strict control over receipts and payments of cash known as **"Internal check system"**.

2 **Misappropriation of goods :** Misappropriation of goods is very common specially when goods are not bulky and are of high value. It is very difficult to detect such misappripriation of goods unless proper records of stock inward and outward are maintained in the organisation. Only proper accounting for purchases and sales, stock taking and periodical checking of stock can reduce the possibility of such fraud.

3 **Falsification or Manipulation of accounts :** Accounts may be manipulated by those responsible persons who are in the top management of the organisation in order to achieve certain specific objectives. The accounts are prepared in such a manner that they disclose only a distorted picture and not the true picture. Thus, the true picture of the business is concealed and a distorted picture is revealed. Manipulation of accounts may be resorted to by various means and a few may be mentioned as follows:

i) Charging excess or less depreciation

ii) Writing off of excess or less bad debts

iii) Providing for excess or less doubtful debts

iv) Over-valuation or under-valuation of closing stock

v) Suppressing sales and purchases or showing fictitious sales and purchases

vi) Charging capital expenditures to revenue and vice-versa

vii) Inflating or deflating expenses and incomes, etc.

**Window dressing :** When accounts are prepared in such a way that apparently on the face of it, they indicate a much better picture than actually what they are, it is known as "window dressing". The main objectives behind this are :

i) to obtain further credit

ii) to attract prospective partners or shareholders

iii) to earn more commission when payable on the basis of performance

iv) to win the confidence of shareholders

v) to raise the price of shares in the market by paying higher dividend so that shares held may be sold.

**Secret Reserves :** When accounts are prepared in such a way that apparently on the face of it, they disclose worse picture than actually what they are, it is known as "Secret Reserves". The main objectives behind this are :

i) to avoid or reduce the tax liability

ii) to conceal the true position from the competitors

iii) to reduce the price of shares in the market by not paying dividend or paying lower dividend so that the shares may be bought at a much lower price.





Since these frauds are committed by those persons in the organisation who are at the helm of affairs like directors, managers, financial controllers, etc. it is really difficult to detect such frauds. Therefore, the auditor must be extraordinarily vigilant and should make searching enquiries to arrive at the true position.

### 1.3.3 Advantages

There are a number of advantages in having accounts audited even when there is not legal requirement for doing so. Some of the important advantages are given as under :

1 Auditing accounts carry greater authority than accounts which have not been audited.

2 If accounts are audited then errors and frauds can be detected and rectified in time.

3 A regular audit of accounts creates a scare amongst the employees of accounting department and also exercises a great moral influence on the client's staff thereby restraining them to commit frauds and errors.

4 Audited accounts are readily acceptable by the Revenue authorities, i.e. Income Tax, Sales Tax and land Revenue Departments, etc.

5 Audited accounts facilities settlement of claims on the retirement/death of a partner.

6 Financial institutions like Banks, LIC, HDFC, HUDCO and similar organisations consider audited accounts for processing loan applications.

7 In case of Joint Stock Company where ownership is divorced from management, audit of accounts ensure the shareholders that accounts have been properly maintained, funds are utilised for the right purpose and the management have not taken any undue advantage of their position.

8 Audited accounts help in the early settlement of claims from the insurance company in the event of loss of property by fire or on happening of the event insured against.

9 Disputes between the management and the labour unions, on matters of payment of bonus and higher wages can also be settled if accounts have been audited by an independent person.

10 Auditored accounts also help in the determinations of purchase price for a business.

11 The admission of a new partner is facilitated if audited accounts of 2 to 3 years available for examination. The incoming partner may decide the terms and conditions for joining the partnership firm after studying the audited balance sheet.

12 The audit of accounts by a qualified auditor also helps the management on various matters, i.e., report on internal control system of the organisation or setting up of an internal audit department, etc.

**Check Your Progress B**

1 List the types of clerical errors.

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2 Distinguish between errors and frauds.

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3 What do you mean by Window dressing.

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4 Fill in the blanks with the appropriate word given in the bracket :

i) When two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as ..... (errors or omission/compensating errors)

ii) ..... are always committed deliberately and intentionally to defraud the proprietors of the organisation. (errors/fraud)

iii) The main objective of ..... is to avoid or reduce the tax liability. (window dressing/secret reserves)

iv) To determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is ..... of an audit. (primary objective/secondary objective)

5 State whether the following statements are True or False.

i) The main object of auditing is to detect frauds from the books of accounts.

ii) The allocation of amount between capital and revenue expenditure is a compensating error.

iii) Audited accounts are free from errors and frauds.

iv) The main purpose of auditing is to report on the effectiveness of the internal check system of organisation.

v) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.

vi) An auditor is appointed to report on the financial position of the company after carrying out an analytical examination of the books of accounts, related documents and internal and external evidences.

vii) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.

## 1.4 DIFFERENT CLASSES OF AUDIT

There may be different classes of audit. Let us discuss them one by one.

1. **Audit under statutes : An Audit undertaken under Statute or Law is called "Statutory Audit".** Audit of accounts of Joint Stock Company is compulsory under the provisions of the Companies Act. The company audit is, therefore, statutory audit. Under such an audit, the rights, duties, procedure for appointment, qualification of auditor, etc. are laid down by the statute so that they cannot be restricted in any way by the board of directors or the shareholders of the company. Besides Joint Stock Companies incorporated under the Companies Act, audit is





compulsory under the different laws that govern them in the case of following undertakings :

i) Banking Companies

ii) Insurance Companies

iii) Cooperative Societies

iv) Public and Charitable Trusts

v) Local Authorities and Government Undertakings.

2 **Audit of accounts of private firms :** The Partnership Act of 1932 does not require any audit of partnership firms. But these days most of the partnership agreements provide for audit of partnership accounts. As such, in the case of partnership firms, the auditor is not appointed under any law but by an agreement between the auditor and the partners. The rights, duties, scope of work, audit fee, etc., of the auditor are determined by the terms of contract. It is the duty of the auditor to complete his assignment in the light of the agreement and make a written report on the work completed by him.

The auditor should pay attention to the following documents and points while conducting the audit of a partnership firm.

i) Partnership Deed

ii) Nature of Business

iii) Borrowing powers of the partners

iv) Profit sharing ratio of the partners

v) Partnership Act, 1932.

If the accounts of the partnership are audited by an independent auditor, the following advantages can be derived by a partnership firm :

i) Settlement of accounts at the time of retirement death of a partner.

ii) Easy to raise loans from different sources, i.e., banks, financial institutions and companies.

iii) Settling disputes among the partners on various matters and facilitates admission of a new partner.

iv) Audited accounts are readily acceptable by the tax authorities for the purposes of assessment.

v) Early detection of errors and frauds and other general benefits flow from an audit.

3 **Audit of accounts of private individuals :** Audit of accounts for a sole proprietor is optional and not obligatory under any statute. It is always advisable for a sole proprietor, whose income is large and derived from various sources and the expenditure is also vast and varied, to get the accounts audited by a qualified person. The person so appointed must get clear instructions from the client regarding the nature and scope of his work, limitation, audit fee and time to complete the work. He should carry out the work with utmost care to avoid disputes later on. In addition to the advantages, common to all firms of audit, the following advantages may be derived by a sole proprietor :

i) Audited accounts are readily accepted by the tax, authorities for the purpose of assessment.

ii) Audited accounts are helpful, after the death of the sole proprietor, in the preparation of estate duty accounts by the executors.

iii) Moral check on the staff of the client as the staff cannot dare to commit frauds.

iv) All incomes and expenditures can be properly accounted for.

4 **Audit of trust accounts :** Trusts are often created for the benefit of religious or charitable institutions. Sometimes, trusts are also created for the benefit of minors

or widows. In both these cases the underlying idea is that the money should be used for those for whom it is meant. A 'Board of Trustees' is created to look after the property or the funds left by the Testator. But these trustees may either present no accounts or present fictitious accounts thereby misappropriating the trust funds without the knowledge of the beneficiaries. To avoid such happenings, a provision is invariably made in the 'Trust Deed' for audit of accounts by a qualified auditor. The audit of accounts of trusts is good both for the trustees as well as for the beneficiaries. Once the trust accounts have been audited then no one can make unnecessary criticism against the trustees and the beneficiaries are assured of the proper utilisation of funds.

**External and Internal Audit**

An audit undertaken by an independent agency is called external audit. The auditor so appointed will carry out audit and submit his report on the financial conditions and the working results of the organisation to his appointing authority. The audit of a Joint Stock Company can be undertaken only by a qualified accountant i.e., Chartered Accountant, whereas it is not necessary for a private individual or partnership firm to get their accounts audited by a Chartered Accountant. However, it is always advisable to appoint a qualified auditor to check and report on the accounts.

Internal audit is an independent appraisal of activity within the organisation by specially assigned staff. Internal auditor is an employee of the organisation and his work, duties, rights and responsibilities regarding audit are determined by the management. He does not enjoy independent status. He has to evaluate the correctness of the accounting records, accounting system adopted in the enterprise and the internal control system followed in the organisation. It is not necessary that an internal auditor be a Chartered Accountant.

## 1.5 MODES OF AUDIT

An auditor may conduct audit on continuous, periodical or interim basis. Let us discuss them in detail :

### 1.5.1 Continuous Audit

A continuous audit is one, where the auditor's staff attends to the checking of the accounts work at appropriate intervals, say, weekly, fortnightly or monthly during an accounting period. In this system, the audit proceeds as accounting progresses. Continuous audit is followed in big organisations where numerous transactions of varied nature are to be checked and where the audited accounts must be ready immediately after the close of the financial year.

**Advantages**

1 It facilitates detailed and exhaustive checking of the accounting records and related documents as the auditor gets sufficient time at his disposal.

2 Errors and frauds are quickly detected and rectified as the auditor checks the accounts at frequent intervals.

3 Since the auditor pays surprise visits to his clients, it exercises moral check on the staff of the client and as such, they keep the work up-to-date and date not commit frauds.

4 The auditor can keep himself in constant touch with the activities of the business concern. He can give proper attention to all the relevant points necessary for efficient performance of his job.

5 Since audit work is carried out thoroughly throughout the year, the audited final accounts can be presented to the shareholders soon after the close of the financial year without any wastage of time.

6 It facilitates preparation of interim accounts when the question of declaration of interim dividend arises.





7 Since the audit work is uniformly spread over the year, there is no pressure of work at a particular point of time. Proper planning of audit can be made in advance and the audit staff can be kept busy throughout the year.

**Disadvantages**

1 Figures of the accounts already checked by the audit staff can be tampered with by the staff of the client.

2 Audit staff may not complete the work on each visit. As a result, they may forget to clear off the queries or to follow the work left on the last visit.

3 Continuous audit is not economical for small enterprises.

4 Accounting work of the client may be dislocated by frequent visits of the auditor and thus, lots of inconvenience may be caused to the client.

5 The audit staff may be required to take extensive notes in order to avoid any loose ends and alteration in figures between the two visits.

However, these limitations of continuous audit can be overcome if the auditor strictly prohibits the clients staff not to change the figures and pass journal entries to rectify the errors discovered. Special ticks and coloured pencils may be used to discover the changed figures. As far as possible the work at each visit must be completed and notes regarding the incomplete work or queries be kept in the current audit file.

### 1.5.2 Periodical or Final Audit

A periodical or final audit is one where the auditor takes up the audit work only at the close of the financial year when all the accounts are balanced and a trading and profit and loss account and the balance sheet are prepared. In the case of such an audit, the auditor visits his client only once a year and completes the entire audit work at one stretch. This form of audit is convenient and useful specially in the case of small business houses.

**Advantages**

1 Auditor attends to the work at a particular time and completes the whole work at one stretch.

2 There is no danger of the client's staff being changing the figures as the entire records remain in the possession of the auditor until the audit work is complete.

3 There is no dislocation in accounting work and inconvenience to the client's staff as the auditor comes only for a fixed period in a year.

4 Periodical audit is less expensive and as such it is specially suitable for small business houses.

5 There is no possibility of losing the thread of work of the auditor since the entire work is completed in one stretch.

**Disadvantages**

1 As the detailed checking is not possible there are greater chances of errors and frauds remaining undetected.

2 The presentation of audited accounts to the proprietors specially in case of Joint Stock Company is delayed and as such declaration of dividend is also delayed.

3 Periodical audit is not suitable in case of big business houses.

### 1.5.3 Interim Audit

It refers to an audit which is conducted for a part of the accounting year for some specific purpose, such as, declaration of an interim dividend by a Joint Stock Company. In other words, it is an audit which is conducted in between the two annual audits. This kind of audit involves a complete audit of the accounts prepared for a part of the year.

Advantages

1 Interim audit facilitates the work of final audit.

2 This audit is helpful when preparation of interim accounts becomes necessary for the purpose of declaration of interim dividend.

3 Errors and frauds can be detected more quickly.

4 This type of audit exercises moral check on the staff of the client since it is conducted during the course of the financial year.

**Disadvantages**

1 Chances of altering figures in the accounts which have already been audited cannot be ruled out.

2 Since the audit staff are required to make additional notes after the completion of interim audit, it puts much strain on the audit staff.

3 Interim audit involves additional time and work.

## 1.6 QUALITIES OF AN AUDITOR

An auditor to undertake the audit work of a Joint Stock Company must be a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Besides, the professional qualifications of an auditor should also possess the following qualities :.

1 An auditor should have the thorough knowledge of accounts. It would be difficult for a person to check the accounts if he does not understand how accounts are prepared in different businesses.

2 He should be fully conversant with the various laws of the country such as Income Tax, Sales Tax, Company Law and other relevant laws.

3 He should possess through knowledge of the theory and practice of auditing.

4 He must be honest and possess high moral standards. He should never put his signature or certify any document unless he is satisfied. In London v/s General Bank case, Lord Justice Lindley observed "An auditor must be honest, that is, he must not certify what he does not believe to be true ...".

5 He should have the capability of understanding the technical details of clients' business. He should tactfully ask questions from his clients to obtain the requisite information so as to enable him to understand the technical nature of the transaction.

6 He should be constantly vigilant so that during his checking he should be able to detect frauds and errors and present an accurate picture of the accounts of the organisation.

7 He should maintain complete secrecy of the business of which he is auditing the accounts. He should not divulge any confidential information gathered during the audit.

8 He should carry out his duties cheerfully and conscientiously. He must have the courage of his conviction and show impartiality in his work.

9 The work of an auditor is mechanical in nature. He should show considerable perseverance and should not sign the report unless fully satisfied.

10 He should be able to write his report without ambiguity.

11 He should prove to be an independent person and must not compromise on important issues with his appointing authorities.

12 He should not approach his work with suspicion i.e., with the foregone conclusion that there is something wrong.

13 He should be reasonable in his attitude and must have patience to hear arguments.



14 He should be impartial, methodical and painstaking.

15 He should be courteous so that he can inculcate faith and confidence in the minds of his client's staff.



**Check Your Progress C**

1 Distinguish between external and internal audit.

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2 Distinguish between continuous and periodical audit.

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3 What do you mean by interim audit?

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4 Fill up the blanks with appropriate word given in the bracket.

i) Interim audit ..... the work of final audit. (facilitates/hampers)

ii) ..... audit is less expensive and suitable for small business houses. (periodical audit/continuous audit)

iii) An audit undertaken by an independent agency is known as ..... (Internal audit/external audit)

iv) Audit of accounts for a ..... is optional and not obligatory under any statute. (sole proprietor/Joint Stock Company)

5 State whether the following statements are True or False.

i) Interim audit is compulsory under the Indian companies Act, 1956.

ii) Periodical audit is an internal audit undertaken by an independent agency.

iii) Periodical audit is compulsory for a Banking Organisation.

iv) Continuous audit helps the company to present its audited accounts to the shareholders immediately after the close of the financial year.

v) In the periodical audit the audit report is not submitted by the auditor.

## 1.7 LET US SUM UP

Origin of audit dates back to the period of Mauryas and Hindu Kings in India. However, the growth of Accounting Profession in India is only of recent origin. The Companies Act, 1913 made the audit of accounts of Joint Stock Companies compulsory for the first time. In 1949, Chartered Accountants Act was passed and accordingly the Institute of Chartered Accountants of India was established. As a consequence, the

affairs of the profession were passed on to this Institute. Thereafter, the Companies Act, 1956 elaborated the provisions relating to accounts and audit of companies.

Auditing is the systematic and scientific examination of the books of accounts and records of a business to enable the auditor to satisfy himself that the Profit and Loss Account and the Balance Sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation. The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and results of operation of the organisation. In Investigation is undertaken for some special purpose i.e., to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into : (a) Primary objective, and (b) Secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the Secondary objective is to detect the prevent errors and frauds.

A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, settlement of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, namely, audit under statute, audit of accounts of private firms, audit of accounts of private individuals and audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, namely, continuous audit or periodical audit or interim audit.

Besides being a chartered Accountant, an auditor should possess certain other qualities, such as, knowledge or relevant laws, intelligence, tactfulness, vigilance, honesty and integrity, courage, impartiality, broadmindedness, patience, perseverance, maintaining secretary of his client, commonsense etc.

## 1.8 KEY WORDS

**Auditing :** Systematic and scientific examination of the books of accounts and records of a business as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

**Continuous Audit :** An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

**Errors :** Mistakes committed innocently and unknowingly while making entries in the books of accounts.

**Frauds :** Fictitious entries made in the books of accounts with certain motives.

**Interim Audit :** An audit which is conducted for a part of the accounting year for some specific purpose.

**Investigation :** Examination of accounts for a specific purpose.

**Qualified Auditor :** A person who is a chartered Accountant within the meaning of the chartered Accountants Act, 1949.

**Statutory Audit :** An audit undertaken under any specific Statute or Act.

**True and Fair View :** A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e., the financial statements must not contain errors and frauds.

**Trust :** Institution created mainly for the benefit of religious and charitable purposes. It may also be created for the benefit of minors and widows.





## 1.9 ANSWERS TO CHECK YOUR PROGRESS

A 3 i) false ii) False iii) False iv) False
v) True vi) False vii) False viii) False

B 4 i) compensating errors ii) fraud iii) secret reserve iv) primary objective

5 i) False ii) False iii) False iv) False
v) False vi) True vii) True

C 4 i) facilities ii) periodical audit iii) external audit iv) sole proprietor

5 i) False ii) False iii) True iv) True v) True

## 1.10 TERMINAL QUESTIONS

1 Define the term 'Auditing'.

2 Differentiate between Auditing and Investigation

3 What is continuous audit? Discuss its merits and demerits.

4 Distinguish between Interim and final Audit.

5 List five important qualities of an auditor.

6 List five advantages to a private firm for getting the accounts audited.

7 Discuss briefly the main and subsidiary objects of audit.

8 Briefly explain the following :

a) Errors of commission

b) Errors of principle

c) Prevention and detection of fraud

d) Origin of auditing.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.