Structure

1.1 Meaning of auditing
1.2 Importance of auditing
1.3 Advantages of auditing
1.4 Difference between auditing and accountancy

Learning Objectives
After studying this unit, the student will be able to

• Understand the meaning and importance of auditing
• Understand the differences between auditing and accountancy

1.1 Meaning of auditing

The word ‘Audit’ is derived from the Latin word “Audire” which means to hear. An audit is a simple form developed with the organized system of accounting. In early period person appointed to check the accounts used to hear from the bookkeeper matter relating to the transaction of the business. In course of time the mode of audit changed according to accounting system of different types of business. Auditing is a specialized function having complex, legal, economic implications.

Auditing is concerned with the verification of accounting data with determining the accuracy and reliability of accounting statements. Verification
of accounting data involves a careful evaluation of evidence available to the auditor in support of monetary transactions. The auditor examines internal evidence i.e. the records, vouchers and books of accounts. Auditing thus primarily involves testing the reliability, competency and adequacy of evidence in support of financial transactions of an organization. It is not mechanical ticking of entries in books of accounts with the vouchers of the other records.

Auditing is the process of testing and weighting of evidence. It is analytical, critical and investigative. It has its principle roots not in accounting which it reviews but in logic on which it leans heavily for ideas and method. As well laid out and implemented audit programme helps in auditor to arrive at proper conclusion regarding the accounting statements and they helps him to formulate his opinion.

1.1.1 Definition

Auditing is concerned with the checking of the accounts of the business with a view to find out correctness of the entries recorded in the books of accounts truthful of the transactions and of the result of the business. Some important definitions of auditing may now be examined.

The most commonly accepted definition of audit is given by Spicer and Pegler. According to them audit is such as examination of the books, accounts and voucher of business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, so as to give 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 profit or loss for the financial period, according to the best of his information and the explanation given to him and as shown in books, and if not, in what respects he is not satisfied.

The Institute of Chartered Accountants of India defines “Auditing is a systematic and independent examination of data, statements records operations and performance (financial or otherwise) of an enterprise”. In any auditing situations the auditor perceives and recognize the preposition before him for examination collects evidence evaluations the same and on this basis, formulated his judgement which its communicated through his Audit Report.

Lawrence R.Dicksee defines “Auditing is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transaction to which they relate. In some instance it may be necessary to ascertain whether the transaction themselves are supported by authority.”
Montgomery defines “Auditing is a systematic examination of the books and the records of a business in order to ascertain or verify and the report upon the facts regarding its financial operations and the result thereof”.

R.K. Mautz “Auditing is concerned with the verification of accounting data, determining the accuracy and reliability of accounting statements and reports”.

Batliboi defined a “Audit as an intelligent and critical scrutiny the books of accounts with the documents and vouchers for which they relied upon for the purpose of ascertaining whether the working result for a particular periods as shown by the profit and loss account and also the exact financial condition of the business as reflected in the balance sheet are truly determine and presented by those responsible for their compilations”.

A close analyses of the above definitions bring out clearly the following essential of auditing.

(a) It is scientific thorough systematic examination of books and financial and legal records of the organization.

(b) The purpose of this examination is to ascertain how far they present a true and correct a view of the state of affairs of particular concern.

(c) The accounts have to be prepared by other and not by auditor.

(d) The auditor must satisfy himself and honestly report the reliability and authenticity of the financial statements drawn from them.

(e) The examination of accounting record may be made throughout the year of periodically and

(f) The scope of audit is not limited only to the business concern but it may be duly to non commercial concern also.

1.2 Importance of Auditing

With the rapid increase in the number of companies in the present century, this profession has assumed an ever-increasing role in the business community. It was so because the auditor played a vital role in instilling confidence in the public at large with regard to company form or organization by revealing the fact to them and imposing to check the upon the management. Its strides forwards have been tremendous since various countries passed company legislation with provision making the adult of joint stock companies compulsory. This turned out to be instrumental in establishing it as major profession. This trend was also reinforced by after statutory enactments.
The scope and importance of auditing has been further enlarged by the provisions in the budget of 1948, besides the Joint stock companies, the audit has been made compulsory for other business firms and profession also. It has been provided that in all cases, where the annual turnover exceeds Rs. 20 lakhs or where the gross from profession exceeds Rs. 10 lakhs, the audit of the accounts would be compulsory. This has been provided to ensure that the books of accounting and often records are properly finalized and faithfully reflect the true income of the taxpayer. Thus a large number of business firms and professional would have to get their books on accounts compulsory audited now.

**Accountancy and Auditing**

Book-keeping is an art of recording all the business transactions in the books of account and is mainly related to books of original entry as well as Ledger. This work is, in general, entrusted to junior employees under the direct supervision of accountants. They generally do not process any specialized training as the work of a mechanical nature and in the advanced countries, various machines are used for such jobs. Accountancy is mainly concerned with the preparation of summaries and analysis of the records furnished by book-keeping. Earlier, no differentiation was made between accountancy and book-keeping but with the increase in size and complexity of business became essential.

**Accountancy begins where book-keeping ends.** It is concerned with

(a) Ensuring that all financial transactions have been correctly recorded in the books of account.

(b) Preparing a trial balance

(c) Preparing profit and loss account and balance sheet

(d) Passing adjustments and rectification of entries.

Auditing begins where accounting ends. Auditing is quite distinct from book-keeping and accountancy as they differ in their respective objects and nature. This distinguished feature of auditing is that it analytical and essentially retrospective where as accountancy is primarily constructive and concerned with current recording of business facts. The auditor examines the books of accounts, the profit and loss of account and balance sheet prepared by the accountant. An accountant is constructive where as auditor is primarily an analyst. Auditing is mostly carried out by trained professional accountants organized to offer their services to the public. In India, an auditor should be Chartered Accountant but such qualification is not necessary for an accountant responsible for the preparation of account of a concern.
Auditing and Investigation

Auditing is distinct from investigation. Investigation is the examination of the books of account for a specific purpose. Ex. Detection of suspected fraud, continuing losses. High labour turnover inadequate working capital etc. Investigation may be conducted in addition to the regular audit of accounts. Investigation covers several years say 2, 4, 5, or 6 years to find out the average earning capacity financial position, etc., of concern while audit usually relates to one year.

Investigation may be carried out on behalf of outsiders while audit is conducted on behalf of the proprietor only. However, investigation may also be carried out on behalf of proprietors in some cases where fraud is suspected. Given the specific nature of the objective, an investigator is required to be more skilled, critical, and cautious. The information required for this work may not be available ready made. His inquiry for the necessary evidence will have to be beyond what appears in the books and records. Accordingly, he must possess an alert, open-eyed quality to distinguish the clues which may help him in getting to the truth. Unlike the auditor, he does not accept any fact or figure at its face value. He subjects it to close scrutiny. After careful analysis of the relevant evidence, he develops it to serve the interest of the person on whose behalf he has undertaken the work.

Account of joint stock company must be audited according to law while investigation is not compulsory. The investigation is concerned whether the financial policy of the company is being followed or not but in the case of the auditor, he has to state that fact. Ex. Whether the method of the valuation of stock is being consistently followed or not, or whether there has been change in the method of providing depreciation and its effect on profit, etc.

1.3 Advantages of Auditing

There are advantages in auditing the accounts even when there is no legal obligation for doing so. Some of the advantages are listed below.

1. Audited accounts are readily accepted in Government authorities like income Tax Dept., Sales Tax dept., Land Revenue departments, banks etc.

2. By auditing the accounts Errors and frauds can be detected and rectified in time.

3. Audited accounts carry greater authority than the accounts which have not been audited.
4. For obtaining loan from financial institutions like Banks, LIC, HUDCO, HDFC, IFCI etc., previous years audited accounts evaluated for determining the capability of returning the loan.

5. Regular audit of accounts create fear among the employees in the accounts department and exercise a great moral influence on clients staff thereby restraining them from committing frauds and errors.

6. Audited accounts facilitate settlement of claims on the retirement/death of a partner.

7. In the event of loss of property by fire or on happening of the event insured against, audited accounts help in the early settlement of claims from the insurance company.

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

9. To determine the value of the business in the event of purchase or sales of the business, audited account will be the treated as the base for the evaluation.

10. The audit of accounts by a qualified auditor also help the management to understand the financial position of the business and also it will help the management to take decision on various matters like report in internal control system of the organization or setting up of an internal audit department etc.

11. If the accounts have been audited by an independent person, disputes between the management and labor unions on payment of bonus and higher wages can be settled amicably.

12. In the event of admission of a new partner, audited accounts will facilitate the formation of terms and conditions for joining the new partner. Last 3 years audited accounts and balance sheet will give a general idea about the growth and financial position of the business to the new partner.

Limitations of Auditing

Even through it offers many advantages to the various sections of the society, still it suffers from the following limitations.
1. **Auditing does not reveal the complete picture**: Auditor has to depend on the facts shown by the books. Auditing may not reveal the manipulation of accounts.

2. **May not get complete or correct information or full explanation**: Auditor has to depend on the explanation and information from the client. As such his report may become handicap.

3. **An auditor is not expected to be expert in all the areas**: He cannot be supposed to have the knowledge of an engineer or an advocate in practice. Auditing may not serve any purpose unless until the auditor is quite independent and possess high moral standards.

4. **No guarantee of correctness**: Auditing does not give any guarantee as to correctness of the financial account of the concern.

5. **Even the audited accounts may be incorrect some times**: Sometimes the audited accounts may not be correct.

6. **Auditing is more like a postmortem examination**: No use of past events of those already occurred. It is more helpful for past and less helpful for the future.

7. Audit work is undertaken by auditor in a phased way and he is not able to remain independent.

8. **Nothing to do with policies**: Audit has nothing to do with policies, efficiency, effective management.

9. Auditor does not disclose to the oners as to how their capital might have been used in a better way.

### 1.4 Difference between Accountancy and Audit

The difference between accountancy and audit was clearly brought in case of commissioner of Income Tax Vs. G.M. Dandekar. In this case the auditor was appointed to prepare accounts for tax purpose. He had no instruction to audit the accounts. But he was charged with negligence and breach of duty of not conducting audit and for not discovering frauds. The auditor made it clear in his certificate that he acted only as an accountant. It was held by the court that the inductor did not act as an auditor and hence not liable.

The following are some of the important points of difference between Accountancy and Audit:

...
1. **Nature**: Nature of accountancy is primarily constructive. It is mainly concerned with current recording of business facts. Auditing, on the other hand, aims at examining the correctness of accounts prepared by the accountant.

2. **Scope**: Accountancy refers to the preparation of final account and its interpretation while auditing refers to examination checking of these accounting records.

3. **Objects**: The primary object of accounting is to ascertain trading result of a business during a financial year, while object of auditing is to certify the correctness of the financial statements prepared by the accountants.

4. **Qualification**: An accountant need not be a charter accountant, but an auditor must be chartered accountant.

5. **Appointment**: An accountant is appointed by the directors hence he is answerable to them. But an auditor is appointed the shareholder to whom he is answerable.

6. **Commencement**: Accountancy begins or starts where bookkeeping ends. But auditing begins where accountancy ends. In other words, the work of auditing starts only when the work of accountancy has been completed.

7. **Reporting**: Accounting does not submit any separate report the financial statements prepared by him. But an auditor prepare a report and submit it to the management of the business concern.

8. **Knowledge**: An accountant need not be expert in the work auditing. But an auditor must have been thorough knowledge principle of accountancy, otherwise he cannot perform his job of auditing satisfactorily.

### Short Answer type Questions

1. What is an Audit?
2. What is meant by Accounting?
3. Define Investigation.

### Long Answer type Questions

1. Explain the importance of Auditing.
2. Explain the Advantages of Auditing.
3. Explain the difference between accounting and Auditing.
4. What are the limitations of Auditing?
2.1 Objectives of Auditing

2.2 Detection and prevention of Errors.

2.3 Fraud.

Learning Objectives

After studying this unit student will be able to

- Understand the examining and internal check of accounts
- Understand different types of errors
- Understand about fraud

2.1 Objectives of Auditing

The fundamental object of auditing accounts is to find out after going through the books of accounts whether the balance sheet is prepared according to the prescribed form and it is exhibiting the correct and true financial position of the concern on the date on which it is prepared. The second object is to see whether the profit and loss accounts is properly prepared according to the Companies Act and it is showing the correct and exact profit and loss of the concern for the period for which it is prepared.

Thus the primary object of audit always is the establishment of the degree of reliability of the financial statements and produce a report on the organisation’s
financial condition and profitability. An auditor in order to satisfy himself about the accuracy of the books of accounts so that he may report upon the actual financial position and the working result of the organisation must.

(a) Examine the system of internal check.

(b) Check the arithmetical accuracy of the books of accounts by verification the posting, casting and balancing etc.

(c) Verify the authencity and validity of transactions entered into the books with the relevant supporting documents.

(d) Ascertain that proper distinction has been made between items of capital nature and those of a revenue nature and that the amounts of various items of income and expenditure corresponding to the accounting period.

(e) Confirm the existance and value of assets and to verify liabilities.

(f) Verify whether all the statuary requirements as regards the books of accounts that should be maintained as well as the form the form in which the final accounts should be drawn up have been duly complyed with.

2.2 Detection and prevention of errors

Thus the subsidiary objects of the auditing are

(i) Detection and prevention of Errors: This is the fundamental object for the sole traders and partnership firms, it is the duty of the Auditor must pay attention for every error how much innocent it may be. The following are the types of errors

1. Error of omission

2. Error of commission

3. Error of principle

4. Compensating or offsetting errors

5. Error of duplication

1. **Error of omission**: These error arise when the transaction is entirely omitted from the books. The failure to record the sales in the sale book means the account if the customer who received the goods will not be debited and the sales account will not be credited by the amount of the omitted sale. Error of omission do not in any way effect the trial balance.

2. **Error of Commission**: These are the most common errors.
These errors consist of wrong entries, posting, additions, transfers etc. The following are the examples of such errors.

(i) Making a wrong entry in a book of original entry.
(ii) An item for which double entry is not completed.
(iii) An item posted to the wrong side of an account.
(iv) The same amount posted twice to an account.
(v) Error in taking out balances of ledger accounts.
(vi) Error of commission may or may not affect the trial balance.

3. Error of Principle: These errors of principle arise when a particular entry of course has not been recorded according to the principles of double entry, of course, errors of principle do not made between capital and revenue. An item of expenses may be debited to an asset account instead of to an expenses account or vice versa.

4. Compensating Errors: These are the errors that counteract each other. It is much difficult to discover such errors. These error cannot.

5. Errors of Duplication: Such errors arise when a transaction is entered twice in the books or original entry and posted twice to the concerned ledger accounts. This may be either due to failure on the post of recording clerks to distinctly mark the invoices and other vouchers after these have been entered in the books of original entry.

It is difficult to detect such errors as they will not affect the trial balance. Vouching should be done very carefully to detect such errors.

2.3 Fraud

Fraud means false representation of entry made intentionally or without belief in its truth with a view to defraud somebody. Detection of fraud is considered to be of the important duties of an auditor. As a matter of fact, originally audit was conducted mainly with a view to detect fraud whenever it was suspected. The system of internal check aims at the prevention of fraud. If the auditor finds that the internal check system is defective and will not prevent the commission of frauds, he should suggest a better system.

The following are the chief ways in which fraud may be perpetrated:

1. Embezzlement of Cash;
2. Misappropriation of Goods; and
3. Fraudulent manipulation of Accounts.

1. Embezzlement of Cash

There is greater possibility of defalcation of money in a big business house than in the case of a small proprietary business where the proprietor has a direct control over the receipts and payments of cash. In a big business house, the system of receipt and payment of cash should be such that the work of one clerk in automatically checked by another clerk. Such a system is known as auditing as “internal Check” system which will be dealt with in detail later on. It is easier to misappropriate cash, and, therefore, the auditor will do well to pay particular attention towards cash transactions.

Cash may be misappropriated by

(a) Omitting to enter any cash which has been received: or
(b) Entering less amount than what has been actually received; or
(c) Making fictitious entries on the payment side of the cash book; or
(d) Entering more amounts on the payment side of the cash book than what has been actually paid.

In order to discover fraud under (A) and (b) above, the auditor should check the debit side of the cash book and with rough cash, salesmen’s reports, counterfoils of the receipt books, agents’ returns and other original records while the fraud under (c) and (d) can be discovered by reference to the vouchers, wage sheets, salary book, invoice, etc.

2. Misappropriation of Goods

Again, fraud may be in respect of goods i.e., misappropriation of goods. This type of fraud is very difficult to detect especially when the goods are less bulky and are of higher value. Proper methods of keeping accounts in regard to purchases and sales, stock taking, periodical checking of stocks, comparing the percentage of gross profit to sales of two periods, necessity for collusion will help to avoid misappropriation of goods.

3. Fraudulent manipulation of Accounts

This type of fraud is more difficult to discover as it is usually committed by directors or managers or other responsible officials with the object of

Showing more profits than what actually they are

(i) So that if they get commission on profits, they may get more commission or
(ii) Their service may be retained by showing to the shareholders that because of their efficiency they have shown more profits and thus maintain the confidence of the shareholders or

(iii) If they hold shares, they may sell them at high price by declaring higher dividends or

(iv) To obtain further credit by showing the financial position of the business better than what actually it is or

(v) To attract more subscribers for the sale of the shares of the company, etc.

**Short Answer Type Questions**

1. Define Error.
2. What is Error of Omission?
3. What is Error of Principle?
4. What is Compensative Error?
5. Define fraud.

**Long Answer Type Questions**

1. Explain the objectives of Auditing.
2. Explain different types of errors.
UNIT 3

Types of Audit

Structure

3.1. Meaning and definition
3.2. Types of audit
3.3 Conduct of audit method
3.4 Features of audit programme
3.5 Merits and Demerits of audit programme

Learning Objectives

After completion of this unit, the student will be able to

• Understand the different types of auditing methods
• Understand about how to conduct the audit
• Know about the advantages and disadvantages of audit

3.1. Meaning and definition

The auditor before commencing his work has to drawn programme of work to be performed by him and his staff. Such programme will help the auditor to understand and type of audit to be carried out the technique to be adopted for this propose. According it will indicate.

(a) What work is to be done during the course of the audit
(b) By which member of his staff any particular portion of the work is to done and

(c) Within what time frame any particular work is to be accomplished.

The audit programme cannot be the same for all business units. The programme is to be drawn on the basis of the nature and type of business. Factors such as organizational structure, internal control system in existence and the accounting procedure are to be considered. In the case of new auditor must be find out whether the condition of account, and that of internal control are good.

Definition

According to Montgomery “an audit programme is a list generally in detail of steps to be performed in the course of examination. It control the nature and extent and examination aids, arranging timing and distributing the work, guards against possible omissions and duplications and provides part of evidence of work done”.

According to Howard Stettler. “An auditor programme is an out of lie of all procedure to be followed in order to arrive at an opinion concerning the client financial statements”.

According to professor Meigs, “an audit programme is a detailed plan of the auditing work to be performed specifying the procedure to be followed in verification of each item in the financial statements and living the estimated time required”.

These definition clearly bring out the nature and scope of audit programme. An audit programme is a written plan containing exact detail with regard to the conduct of a particular audit. It consist of procedure undertaken on the particular work done by accountant in carrying out an audit. It is description memorandum or an outline of the work to be done prepared by an auditor for the guidance and control of assistants. An audit programme guide in arranging and distributing of work and in checking against the possibility of the omissions. It is necessary for planning and supervision of an engagement under the first standard of field work.

An audit programme is often used as guide for audit examinations in future. But it is true mainly in case of repeat audits because in an initial audit, the audit programme is tentatively designed on the basis of the information obtained from the client. But even in a repeat audit the past year audit programme cannot automatically be adopted for audit examination in the current year. It will have to be modified in the light of the changes that may have taken place.
since the last engagement. Modification in case of fixed audit programme is a slightly difficult as the senior audit check is allowed to make only minor changes, therein and for any major change he has to get the approval of the auditor.

3.2 Type of Audit

An audit examination may be performed in many ways, depending on needs and convenience of the enterprise. It may be once in year after the financial statements have been prepared or continuously round the year at regular or irregular intervals. On the basis of organisational structure of the enterprises under audit, independent audit may be classified as statutory audit and private audit.

Statutory audit: Where audit in the case of an enterprise is made compulsory by law it is called statutory audit. Statutory audit is carried out in the case of following organisations.

(a) Joint stock companies registered under the companies act.
(b) Banking companies regulated under the banking companies act of 1949.
(c) Insurance companies governed by insurance at 1938.
(d) Cooperative societies registered under various religious societies act of the states.
(e) Public and charitable trust registered under various religious and endowment acts.
(f) Public corporations set up under the act of parliament or state legislatures.

Important Features

The main features of statutory audit are as under

(a) The audit is to be carried out only by person who are qualified under the Chartered Accountant act of 1949.
(b) The rights duties and liabilities of an independent auditor are governed by the law. They can not be curtailed by the owner, shareholder of the enterprise.
(c) An independent auditor is to represent the share holder owners, and is not to subserve the interest of the management of the enterprise.
(d) A statutory audit cannot be partial or incomplete in any respect.
Advantages

The shareholder of a company have no access to the books of account and therefore the accounts which have been maintained by the director are audited by an auditor. Shareholder naturally look up to the auditor for his expert opinion as to the claims made by the management regarding the operation and financial conditions of the enterprises. Moreover in the present day world these are multifarious means of credit available to company and the economic importance of its business activities has vastly increased. As such a compulsory independent reporting on its statements by a professionally qualified and competent person is only proper. An auditor acts as a check upon dishonest employees whose number may be very large in the organization.

In case of cooperative societies or societies registered under the societies registration act, a compulsory audit serves the triple purpose of

(a) Being a check against frauds by the managing committee.

(b) Helping in the proper maintenance of books and accounts and

(c) Shielding the member of the managing committee against uninformed and baseless criticism.

In case of statutory corporation the need and importance of a compulsory independent audit cannot be over emphasized because they are financed by public money.

Audit of Trustee Accounts

Trust are created for the benefit of some institutions, widows, orphans, minor etc. The trustee looks after the property left over by the testator. They collect the results of the property dividends on the areas etc., and distribute the income of the beneficiaries according to the terms of the trust deed. As the widows, minor etc., for the benefit of whom these trust are created are not in position have access to the books of account or criticize them they may be defrauded by the trustees. Hence a compulsory independent audit is necessary not only to protect the interest of the beneficiaries against possible frauds by the trustee, but also in the interest of the trustee themselves who may not possess adequate knowledge of the Trust law.

Private audit: Where audit in the case of an enterprises is not compulsory by law, though it is opted for by the enterprises in view of the several benefits resulting from it, is called private audit. The purpose of audit of each form of private enterprises differs according to its need. However in the case of audit private firms and proprietors concern, the auditor follows
standard audit practises conventions in accounting and applied care and skill to the same degree which he applied to other audits.

**Advantages**

The following are the main advantages of private audit

(a) Audited statements and accounts like make a reliable basis for assessment of tax liability under the various laws, such as income tax, wealth tax, sales tax etc., as the tax authorities readily believe them.

(b) Audited statements and accounts are valuable in settlement of claims and disputes between partners.

(c) Audit by a professional auditor serves as an assurance to the owners that the accounts of business transactions are being properly maintained and that are no frauds and errors by employees of the concern.

(d) Audited statements and accounts facilitate the process of raising loan and advance from financiers and

(e) The clients also get a number of other advantages of audit when their account are audited.

### 3.3 Conduct of Audit methods

Audit may be conducted under different method. The methods of audit refer to the extent of work to be performed and or the manner of its execution. The method which the auditor or the business unit manner adopt on depend on the nature of the business the volume of worker and the purpose of audit. Whatever may be method the object is to ensure the correctness and truthfulness of the accounts audited. Generally the methods of audit are as follows

(a) Continuous audit

(b) Periodical audit

(c) Interim audit

(d) Occasional audit

(e) Standard audit

(f) Balance sheet audit

In the selection of any method the client must be instructed to the suitability from the point of view of cast and purpose of audit. A detailed analysis
of some important method is made with a view to find out the suitability of the methods for the different types of business units.

**Continuous of audit:** It is also called Audit or Running audit. A continuously audit is one in which the audit staff is engaged continuously in checking the accounts of the client during the current financial year. It is of great help to relatively bigger concern. It is not much use of small concern assists accounts can be audited at the end of the financial year without much loss of time. A continuous audit is applicable in the following cases.

(a) Where the volume of the transaction of very large.

(b) Where the management require the view of financial position of their concern monthly or quarterly.

(C) Where not satisfactory system of internal check is in position and

(d) Where it is desired to present the account just after the close of the financial year, as in the case of the bank.

Advantages of continuous audit: Following are some of the main advantages of continuous audit

1. **Efficient:** The auditor of his staff gets sufficient time for the audit work. The account books are properly inspected and checked in detail. The auditing work would never be done in a hurry. So the audit will be more efficient and detailed.

2. **Quick discovery of errors:** Errors and frauds can be discovered easily and quickly as the auditor checks the accounts as regular intervals. As the auditor visit his clients, say after a month or two or so, the number of transactions will be small and hence the errors will be detected easily and quickly.

3. **Relief to auditor:** In a continuous audit, the several visit paid by the auditor to the client office enable his work to proceed easily and smoothly. It also boosts his confidence in his capacity to handle his work with efficiency and effectiveness.

4. **Knowledge of Technical details:** Since the auditor remains more in touch with the business he is in position to know the technical and hence it can be great help to his clients by making valuable suggestions.

5. **Moral check:** In continuous audit the auditor may also pay surprises visit to the client office. This exercises undoubtedly a great moral check on the staff of the client who are overt confident because of the ever present apprehension of an impending visit by the auditor.
6. **Interim dividend**: Where the director of a company wish to declare an interim dividend continuous audit will help in the preparation of the interim accounts with out much delay.

7. **Keep the client staff regular**: As the auditor visit the client at regular intervals the clerks will be very regular in keeping the accounts up-to-date.

**Disadvantage of continuous audit**

In spite of several advantages of continuous audit there are certain disadvantages of such an audit which are as under

1. **Dislocation of work**: Auditor frequent visit dislocate the work of the client staff. The efficiency of the client staff may be affected.

2. **Alternation of figures**: The record of the transaction may be altered fraudulently after they have been audited.

3. **Queries may remain outstanding**: The audit clear may loose the thread of his work and the remain outstanding as there might be long internal between the two visit.

4. **Expensive**: Continuous audit is very costly due to heat audit fees and other incidental expenses connected with the audit staff.

5. **Unhealthy relationship**: Unhealthy relationship is develop between the audit staff and the staff of the client due to the frequent visit of at the audit staff.

**Periodical Audit**: This is also known as final audit or annual audit. The audit is very useful to small concerns. It is common understood as an audit which is carried out often at the close of the accounting year. Most of the companies have audited their accounts under this system.

But in the case of large concerns it take more time to complete the audit and hence presentation of accounts to the share holder is delayed. The share holder are usually very anxious for it dividends which cannot be declared until the final accounts have become prepared and audited.

**Advantages of periodical audit**

The following are some of the main advantages of periodical audit

1. **Economical Period**: Periodical audit is economical and suitable particularly small sized business units.
2. **Smooth flow of work**: The work of the audit proceeds in uninterrupted manner and there are no intervals in the case of continuous audit.

3. **Little chance of collusion**: There is no possibility of friendly ties developed between the audit staff and the client staff and as such the chances of any collusion between them are minimized.

4. **No loose of interest**: There is no loss of link in the work as the entire audit is completed in a single continuous session.

**Disadvantages of periodical audit**

Some of the disadvantages of periodical audit are given below

1. **Delay**: As the work of audit usually takes along time to be completed, the presentation of final accounts in the annual general meeting is likely to be delayed.

2. **Unsuitability**: In large concern where the number of transactions are voluminous and often quite complex, periodical audit is not practicable and for this reason, it is often not preferred by them.

3. **Non detection of errors and frauds**: For lack of detailed checking, errors and frauds may continue to remain undetected.

**Distinction between continuous audit and periodical audit**

The following are the main difference between continuous audit and periodical audit

<table>
<thead>
<tr>
<th>Continuous audit</th>
<th>Periodical Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Audit work is done continuously through out the year.</td>
<td>Audit work is done at the end of the year.</td>
</tr>
<tr>
<td>2. It is suitable to big concerns.</td>
<td>It is suitable to small concerns.</td>
</tr>
<tr>
<td>3. Detailed checking is possible.</td>
<td>Detailed checking is not possible.</td>
</tr>
<tr>
<td>4. It is expensive.</td>
<td>It less expensive.</td>
</tr>
<tr>
<td>5. Scope for fraud minimised.</td>
<td>Scope for frauds is more</td>
</tr>
<tr>
<td>6. Audit work becomes mechanical</td>
<td>Audit work does not become mechanical</td>
</tr>
<tr>
<td>7. It creates moral checks and client staff.</td>
<td>It does not creat moral check upon the client staff</td>
</tr>
<tr>
<td>8. Accountancy and auditing go together.</td>
<td>Audit begins where accountancy ends.</td>
</tr>
</tbody>
</table>
Interim Audit: Interim audit means an audit which is conducted between two annual audits. Its objectives is to enable the company declare an interim dividend. It involves a complete examination a review of the accounts and records of the business upto the date of the interim audit. Thus interim audit may be ordered for a quarter or six months.

Advantages of interim audit

1. Errors and frauds can be more quickly found and detected during the course of the year.

2. This type of audit is good where the pollution of the interim figure are necessary.

3. There is a moral check on the staff of the client as the account are checked say, after three or six months.

4. The final audit can be completed very soon, if there has been a interim audit.

Disadvantages

1. Interim audit may prove expensive because it involves addition work on the part of the auditor.

2. Figure may be altered in the account which have already been done audit.

3. It will mean that the audit staff will have to prepare notes which they furnish interim audit.

4. Generally the students might confuse the interim audit with continuous audit, we give below the points distinction between the two types of audits.

Distinction between the continuous audit and interim audit

1. Object: The object of continuous audit is not ascertain the profit or loss of the undertaking for a given period. But the objective of interim audit is to certain and check the profit and loss for a given period.

2. Scope of audit: In continuous audit, detailed and expensive checking of books of accounts is done. But in the case of interim audit is detailed and extensive check is books accounts is not done.

3. Period of audit: In the case of continuous audit, the work of audit is carried on upto to any data according to the convenience of the auditor and
his client while in the case of interim audit the work of audit is up to definite data according to the instructions of the client.

4. **Trial balance**: In the case of continuous audit, no trial balance is prepared through the totals of certain accounts may be noted while in the case of interim audit. The trial balance has to be prepared or checked.

5. **Verification**: In continuous audit the verification of assets and liabilities are undertaken at the close of financial year. But in interim audit, the verification of assets and liabilities are undertaken at the time of such audit.

6. **Prepare**: In the case of continuous audit, the auditor’s report is submitted at the end of the financial year while in the case of interim audit, the report is submitted at the time of audit.

**Occasional Audit**

The name itself indicates that it is a type of audit which will be done now and then especially when the possibility of misappropriation or fraud is suspected. This type of audit will be followed by the sole traders and firms.

**Standard Audit**

This type of audit refers where some of the important items are audited thoroughly and other items by test checking. This will be used only where there is a perfect internal check system is in operation.

**Balance Sheet Audit**

In this type of audit the audit is commenced from the balance sheet working back to the books of original entry and relative documents. This system is recently developed in U.S.A. This is essentially a partial audit, since it verifies the items appearing in the balance sheet and does not start the work of verification with primary books. This type of audit can be successful in those organizations where an effective internal check is in operation.

### 3.4 Features of Audit programme

**Definition and Meaning**

The auditor, before commencing his work has to draw a programme of work to be performed by him and his staff. Such a programme will help the auditor to understand the type of audit to be carried out and the technique to be adopted for this purpose. Accordingly it will indicate (a) what work is to be done during the course of the audit (b) by which member of his staff any particular portion of the work is to be done and (c) with in what time frame any particular work is to be accomplished.
The audit programme cannot be the same for all business units. The programme is to be drawn on the basis of the nature and type of business. Factors, such as organizational structure, internal control system in existence and the accounting procedure are to be considered. In the case of a new audit and the auditor must find out whether the conditions of accounts and that of internal control are good.

**Definitions:** According to Montgomery “An Audit programme is a list, generally in detail, of steps to be performed in the course of examination. It controls the nature and extent and examination, aids in arranging, timing and distributing the work, guards against possible omissions and supplications and provides part of evidence of work done”.

According to Howard Stettler, ”An Auditor programme is an outline of all procedures to be followed in order to arrive at an opinion concerning the client’s financial statements”.

According to professor Meigs, “As audit programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item in the financial statement and giving the estimated time required”.

These definitions clearly brings out the nature and scope of audit programme. An Audit programme is a written plan containing exact details with regard to the conduct of a particular audit. It consists of procedures undertaken on the particular work done by an accountant in carrying out an audit. It is description memorandum or an outline of the work to be done prepared by an auditor for the guidance and control of assistants.

An audit programme guides in arranging and distributing of work and in checking against the possibility of the omissions. It is necessary for planning and supervision of an engagement under the first standard of field work.

An Audit programme is often used as a guide for audit examinations in future. But it is true mainly in case of repeat audits because in an initial audit, the audit programme is tentatively designed on the basis of the information obtained from the client. But even in a repeat audit, the past year’s audit programme cannot automatically be adopted for audit examination in the current year. It will have to be modified in the light of the changes that may have taken place since the last engagement.

Modification in case of fixed audit programme is slightly difficult as the senior audit clerk is allowed to make only minor changes therein, and for any major change he has to get the approval of the Auditor.
The following are the main features of an audit programme

1. A well-conceived, carefully executed audit programme gives order points and coherence to the audit.

2. The audit programme involves considerable amount of thinking and planning on the basis of past experience.

3. The audit programme contains the work to be done, members of the staff responsible for the work, and the time allotted and consumed in each section of the audit.

4. An experienced auditor may get active cooperation from his staff with the help of a sound scheme drawn out by him.

5. The audit programme should be flexible. It must be chalked in such a manner that if there may be need for revision, it may be carried out without difficulty. Unless it is reviewed frequently, it may become out of date also. Thus, the audit programme should not become routine and should not cut the initiative of the audit staff.

6. The audit programme should encourage audit staff to conduct surprise checks outside of the programme.

7. The juniors who are actually undertaking audit work should be encouraged to come forward with their suggestions.

8. The common function to all audits needs the preparation involves verification, examination, and vouching of the books of accounting. The audit programme must contain these common functions, special points to be observed in the case of different types of business also.

3.5 Merits and Demerits of Audit Programme

Merits of Audit Programme

The audit programme is helpful to the auditor in many respects. The merits of such an audit programme may be outlined as below:

1. Efficient distribution of work: The audit programme may be prepared keeping in mind the level of competence and experience of each staff member of the audit team. While senior audit clerks are given relatively complex assignments, the junior are made responsible for routine work. This makes for smooth and efficient execution of the work.

2. Staff on leave: The auditor can keep consistently in touch with the work done by his staff. Even if a junior auditor or audit staff is absent from duty, it would be possible for the information available in the programme.
3. **Systematic manner**: Naturally the programme avoids the possibility of leaving out verification of certain information and records relating to the business. Thus it ensure that is carried out in a systematic manner.

4. **Responsibility**: In case of fraud or error has remained undetected the responsibility for negligence can be fixed on the clerk who had performed that work.

5. **Ground work for audit operations**: It has down a firm’s basis for audit operation in the current as well as future years. Even if there is a change in the staff conducting the audit, the new staff will have no difficulty in knowing what is required to be done by them in any audit operations.

6. **Uniformity**: It may also result uniformity in the work done by similar programme from time to time. The work done by audit staff will be uniform and standard quality because all of them follow the programme prepared by the same auditor.

7. **Basis of subsequent revision**: It serves as the basis for revision in the audit programme in the light of any charges taking place within the enterprise as also experience gained in the course of conducting the past audit.

8. **Control**: It serves as ready checklist of procedures to be applied and the work already finished. Supervision and control of the work can be undertaken and conveniently as every work is undertaken in plant way.

9. **Guidance**: It is a kind of guidance to the audit clerk for the work he has to perform. Thus it is kind of assurance of the auditor the junior will not overlook, essential points while checking the accounts.

10. **Evidence**: It may be used as an evidence by the auditor in the court, in case of charge against him that he has done some work. That is in court of law, the audit programme serves as material evidence justifying the working of the auditor.

**Demerits of audit programme**

The following are some of the demerits of audit programme

1. **Lack of initiative**: Audit programme may cut in the initiative an efficient junior auditor as he has to follow the predetermined plan of audit work. The auditor has to do what he is asked to do and not what he feels like doing.

2. **Mechanical**: Audit work becomes too mechanical audit work is carried out in a routine manner an within the time limit in hurried way.
3. **Lack of Uniformity**: Even the most detailed and comprehensive audit programme cannot possibly provide for each and every aspect of different enterprises for the simple reason that each them may be following its won accounting procedures.

4. **Lack of original approach**: As the audit staff has to stick the programme in all cases, it does not think it necessary to any independent thinking. As such it does not display initiative in exploring new ways of performing the work in hand.

5. **Incomplete audit**: Even if the audit programme is well drawn it may cover everything that might come up during the course of audit.

6. **Inefficiency**: Inefficient audit clerks may cover up the inefficiency under the shelter of audit programme.

The above disadvantages can be overcome by impressing up the audit clerk that the audit programme is only guidance and he should use his initiative and intelligence during the course of audit. He should have encouraged to make suggestion. Further the audit programme should be modified from time to time and made up to date according the experience and changes made in business. Besides this the select of items for audit should be at random so that no one else may form the idea about the way audit is going to take place.

**Short Answer Type Questions**

1. What is meant by Audit Programme?
2. What is continuous Audit?
3. Define periodical Audit?
4. What is occasional Audit?
5. What is meant by Interim Audit?

**Long Answer Type Questions**

1. Explain briefly various types of Audit.
2. Explain the important features of Audit.
3. What are the advantages of private Audit?
4. Explain the advantages of continuous Audit.
5. What are the disadvantages of continuous Audit?
6. What are the advantages of periodical Audit?
7. Explain the difference between Continuous audit and periodical audit.
UNIT 4

Qualification and Disqualification of Auditor

Structure

4.1 Qualification and qualities of an auditor
4.2 Disqualification of an auditor

Learning Objectives

After studying this unit, the student will be able to

• Learn about the qualification which should be attained to become an auditor.

• Learn about the process of disqualification of an auditor.

4.1 Qualification and qualities of an auditor

The necessary qualifications of an auditor who can audit the accounts of limited company are given in section 226 of the companies act, 1956.

1. Provides that only a Chartered Accountant as defined in the Chartered Accountant Act 1949, can acts as auditor of a limited company. A firm where all the partners are practicing Chartered accountant can be appointed by its firm name as auditor in which case any partners may act in the name of the firm. Every chartered accountant has to obtain a practicing license from the institute of chartered accountants of India to act as auditor of company.

2. According to section 226(2), person who holds certificate under the restricted auditor certificates (part B states) rules 1956, is also qualified to act
as auditor of a company, if he has got his certificate periodically renewed under the certificated auditor rules 1961.

Section 4 of the Chartered Accountant act 1949, gives power to the council of the institute of Chartered Accountants of India to recognize foreign qualities to enable a person to become the member of the institute.

Educational Qualification

To become an auditor one must have at least a bachelors degree in Accounting. Some employers may prefer those with masters degree in accounting. MBA with specialization in finance can also be a right subject choice. Courses in economics, business studies and humanities are also helpful. Some universities conduct specialised courses in auditing. Along with subject specialisation, computer literacy is also essential. One must take a course in computer accounting software’s such as Tally or some other related diplomas. One can further take up more advanced courses like ICWA, CA, Company Secretary ship or CPA (certified public accountant in the USA) etc.

There are certain auditor certifications provided by international audit associations such as Institute of Internal auditors (IIA), Information Systems Audit and Control Association (ISACA) etc which are globally accepted. The Institute of Internal auditors gives Certified Internal Auditor (CIA) designation and ISACAp provides Certified Information Systems Auditor (CISA) certification, respectively. CISA qualified Auditors have been recognized as qualified to conduct Systems Audit by Reserve Bank of India (RBI), Ministry of Information Technology (MIT), National Stock Exchange, Comptroller and Auditor General of India (C&AG).

Personal attributes

Accountants should have an aptitude for mathematics and be able to analyze, compare and interpret facts and figures quickly. They must be able to communicate well and have an eye for detail. Familiarity with computerized accounting packages is a great asset for present generation auditors. They must be able to work as a team. Must have high standards of integrity and accuracy as major decisions are made based on financial statements given by them. They must also be reliable and trust worthy.

4.2 Disqualification of an auditor

Section 226(3) lays down that none of the following person are qualified for appointment as auditor of a company.

(a) A body corporate other than a limited liability partnership
(b) An officer or employee of the company;

(c) A person who is a partner or who is in the employment of an officer of employee of the company;

(d) A person who or his relative or partner (i) is holding any security of or interest in, or (ii) is indebted to, or (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, its subsidiary, or its holding or its associate company or a subsidiary of such holding company;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

The service under this section 144 are:

(a) Accounting and book keeping services;
(b) Internal audit;
(c) Design ad implementation of any financial information system;
(d) Actuarial services;
(e) Investment advisory services;
(f) Investment banking services;
(g) Rendering of outsources financial services;
(h) Management services; and
(i) Any other kind of services as may be prescribed.
**Short Answer Type Questions**

1. Who is an Auditor?
2. What is educational qualification of an Auditor?
3. Who appoints an Auditor?

**Long Answer Type Questions**

1. Mention the Qualifications of an Auditor.
2. What are the disqualifications of an auditor?
3. What are the qualities of an Auditor?
Structure

5.1 Various methods of appointment of auditors

5.2 Provisions of Companies Act 1956 relating to appointment and removal of auditor.

Learning Objectives

After studying this unit, the student will be able to

• Understand the different methods of appointment of auditors

• Learn about the provision laid in Companies Act 1956 regarding removal and appointment of auditor.

5.1 Various methods of appointment of Auditors

The appointment of a company auditors is statutory, sections 224,224 of the Companies Act,1956, provides the provisions relating to the appointment of an auditors. The appointment of an auditor can be divided in three categories.

(a) First auditors

(b) Subsequent auditors

(c) Filling of Casual Vacancy
5.2 Provisions of Companies Act 1956 relating to appointment and removal of auditor.

Appointment of First Auditors

Section 224(5) states that the first auditor of a company are to be appointed by the Board of Directors within a month from the date of the incorporation of the company. He holds office until the conclusion of the first annual general meeting of the company. It is not necessary to intimate the appointment of the auditors to the Registrar of Companies.

At the annual general meeting such auditors may be re-appointed or any other person may be appointed in his place. However, if any member wants to nominate another, he has to give notice to the members not less than fourteen days before the meeting.

Appointment of Subsequent (Regular) Auditors

Section 224(1) provides that every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

The company shall within seven days of the appointment, give intimation thereof to every auditors so appointed, unless he is retiring auditors. The auditors so appointed must within thirty of the receipt of intimation, inform the Registrar in writing in Form No. 2313, that he has accepted or refused the appointment.

Appointment by the Central Government

Section 24(3) provides that where at the annual meeting no auditors is appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. The company is required to communicate in an application to the government within seven days of the fact on non-appointment of auditors. Then, the Central Government shall appoint any one of auditors as suggested by the applicant company as an auditor.

However, if the company fails to intimate this fact to the Government, the company and every officer who is in default, shall be punishable with a fine, which may extend to five hundred rupees.

Appointment by the Special Resolution

Section 224(A) states that in case of company in which not less than twenty-five per cent of the subscribed share Capital is held, whether singly or in any combination by.
(a) A public financial institution or Government company or Central Government or any state Government; or

(b) Any financial or other institution established by any provincial or state Act in which state Government holds not less than fifty one percent of the subscribed share capital; or

(c) A nationalised bank of an insurance company carrying on general insurance business.

In case the company failed to pass a special resolution, it shall be deemed that the auditor’s appointment has not been made and the company under section 224 (3).

Casual Vacancy

Section 224(6) provides that the Board of Directors are empowered to appoint an auditor in case of the casual vacancy is caused by death, inability, disqualification, etc., of the company auditors. But where the vacancy is caused by resignation of auditor, such vacancy shall only be filled by the company in general meeting. The remaining auditor or auditors may act notwithstanding the casual vacancy. The auditors appointed in the casual vacancy holds office till the conclusion of the next annual general meeting.

Automatic Reappointment of Auditors

The auditors appointed by whatever authority shall be re-appointed at the annual general meetings unless.

(a) He is not qualified for re-appointment, or

(b) He has given the company notice in writing of his unwillingness to be re-appointed; or

(c) A resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed, or

(d) A notice has been given to the company of an intended resolution to appoint some person or persons in the place of retiring auditors, and

(e) By reason of the death, incapacity, or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with.
Auditors of a Government Company

The auditors of a Government company is appointed or re-appointed by the Central Government on the advice of the Comptroller and Auditors General of India under section 619.

Removal of Auditors

The companies Act 1956 has laid down specific procedures providing many safeguards to ensure the independance of the auditor of company. The relevant provisions are as under Section 224(5) states that the first auditors appointed by Board of Directors may be removed at a general meeting by the company and another appointed in this places. Section 224(7) states that any auditors, appointed(a) in an annual general meeting, or (by the Board to fill a vacancy, or (c) appointed by the Central Government, may be removed from office before the expiry of his term only by the company in general meeting, after obtaining the previous approval of the Central Government in that behalf.

Application for removal of auditor to Central Government.

The application for removal of Auditor of the Company before the expiry of his terms of office must be addressed to the Regional Director concerned to whom the power of Central Government has been delegated. There is no prescribed format of this application. The application should set out in detail the reasons for the proposed removal of the Auditor’s and it must be accompanied by the following documents.-

i. A copy each of the Memorandum and Articles of Association of the Company.

ii. Proof of deposit of requisite fee.

The Regional Director may generally obtain an explanation from the concerned auditor about his views on the matter and may also afford an opportunity of being heard personally.

Short Answer Type Questions

1. Mention various methods of appointment of an auditor.

2. Who is the first auditor.

3. What is meant by casual vacancy?

4. What are the qualifications of an auditor?

5. Who are certified auditors.

6. Who did the Central Government appoint auditor.
Long Answer Type Questions

1. Explain the various methods of appointment of an auditor.

2. What is the procedure of removal of an auditor?

3. Under what circumstances special resolution is necessary to appoint an auditor.
6.1 Remuneration of auditor

Every company has to pay remuneration to its auditor for auditing the company. Section 224(8) states that the person or person who are authorized to appoint and auditor are considered fully complex to fix the auditor remuneration. Thus

(a) If the board of director appoints an auditor the board may fix his remuneration.

(b) If the shareholder appoint an auditor, the general meeting may fix his remuneration. It is not necessary that the remuneration be fixed at the same meeting at which his appointment has been made. Sometimes the general meeting may delegate the power of fixing auditor remuneration to the board.
(c) The retiring auditor who is automatically re-appointed at the general meeting unless a resolution is passed re-fixing his remuneration, is entitled to get the same remuneration as he was getting previously.

(d) The Central Government appoints an auditor it may fix the remuneration.

Apart from the routine audit work and auditor may be entrustable with the task of taxation, writing up of the accounts books and other professional services. In such case the auditor and the board may fix up mutually the extra remuneration payable to the auditor. For this purpose the approval of shareholders shall not be required.

The expenses of the auditor are included in the remuneration. If these expenses are paid separately, it has to be sanctioned specifically by the appointing authority. The profit and loss account shall contain the detailed information regarding the payments made to him.

6.2 Duties of auditor

The duties of an auditor are many and varied some of these duties are statutory and some others are judicial pronouncements. It is the statutory duty to examine the original books of accounts kept by the company to discover in accuracies or omissions therein. He has also to examine the company balance sheet and profit and loss account and other documents and report the true and fair view of the financial position of the company to the member in his audit report.

1. Duties to make report (Audit report)

According to section 227(1A) the auditor shall requires into

(a) Whether the loans and advances made by the company against security are properly secured and that the terms of the loan and advances are not against the interest of the company or its member.

(b) Whether the transaction of the company which are represented merely by book entries are not prejudicial to the interest of the company.

(c) In the case of non banking company whether the company has sold the investment such as debentures shares etc., during the year at price less than the purchase price.

(d) Whether loans and advances made by the company have been shown as deposit.
(e) Whether personal expenses have been charged to revenue account.

(f) Whether the company has allotted shares against, cash whether the cash has actually been received and whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

**Under section 227(2) the report must state**

(a) Whether he has obtained all the information and explanations required by him for the purpose of audit and whether the accounts gives the information required by the Act.

(b) Whether the balance sheet gives a true and fair view of the company affair as at the end of the financial year and profit and loss account gives true.

(c) Whether in his opinion proper books of accounts of required by law have been kept by the company.

(d) Whether proper returns for the purposes of his audit have been received from the branches not visited by him.

(e) Whether or not the balance sheet and profit and loss account been drawn up according to the requirement of the companies act.

If the answer to the above matter is in negative or with qualification, he shall report the reason for the answer.

2. **Sign the Audit report**

Section 2296 requires the auditor to sign the auditor report or sign any other document required by the law.

3. **Statement in Prospectus**

Under section 56(1) if any existing company issues prospectus the financial statement are to be certified by the auditor.

4. **Duty and Certify the Statutory Report**

Section 165 requires the auditor to certify the correctness of the statutory report as far as the number of shares allotted, total number of cash received on shares allotted and the abstract of receipts and payments.

5. **Duty to Assist Investigation**

Section 240(v)(b) requires the auditor to assist the inspector in every possible way with the previous approval of the central government in every possible way when the affairs of the company are being investigated. He has to produce all books and working paper for the purpose.
6. Report and Liquidation

Section 488 (1) states that when company goes into a voluntary liquidation, the auditor must take a necessary report.

7. Comply the directs of the central government

The auditor had to give specific reports on the financial accounts of the company on central government directiveness.

The statutory duties mentioned above can be expanded but they cannot be restricted either by articles of association or the director of the company.

8. Duties as Expected from the various legal cases (other duties)

The following are some of the summarized judicial pronouncements of auditor duties

(a) An auditor must take himself acquainted with his duties under the act and articles.

(b) He is not a detective nor is to approach his work suspicion. He is a watch dog, but not a blood bound.

(c) He must act honestly and with reasonable care, skill and contain and must not allow himself to be influenced by other in the discharge of his duties.

(d) He must show the true financial position of the company as disclosed by the books.

(e) He must report all material fact and points of the shareholders.

(f) He is justified in trusting the servants of the company provided he uses rational care.

(g) If any suspicion occur he is bound to prove deep into it.

(h) He must check the cash in hand and the bank balance.

(i) He must verify the existence of the company securities and see that they are in safe custody.

(j) His report must also contain the matter specified in the manufacturing and other companies (Auditor’r Report) order 1988.
6.3 Rights and Powers of auditors

The appointment of the company auditor is statutory. Therefore the companies act.

1956 has entrusted him with many rights in discharging his duties efficiently and independently. The various rights and powers enjoyed by the auditors are follows

1. Right to obtain information

Section 227(1) also states that the auditor can obtain such information and explanation which are necessary for the performance of his duties from the officers of the company. The term officer includes director, manager or secretary.

2. Right to receive notice of general meetings

Section 231 states that the auditor is entitled to receive a notice of and to attend any meeting of the shareholder. He has the right to speak at such meeting when the accounts re being discussed.

3. Right to make statement at the meeting

The auditor has the right to make any statement or explanation he desires at general meeting in connection with the accounts.

4. Right to Remuneration

The auditor has the right to have him remuneration paid to him provided has completed the work he undertook to do.

5. Right to visit the branches

Section 228(2) provides, where the accounts of an branch office are audited by a person other than the company auditor, the company auditor has right to visit the branches and access to the book of account, vouchers etc., at all times.

6. Right to sign the audit report

Section 229 states that the company auditor has a right to sign the auditor report or any other document of the company required by law to be signed by the auditors.

7. Right to be indemnified

According to section 633 the auditor has a right to be indemnified out of the as against any liabilities incurred by him in defending himself against civil
criminal proceedings by the company provided the judgement is given in his favour.

8. **Right to take legal and technical advice**

The auditor has the right to take legal, expert the technical advice but he must give his opinion in the report, and not that of the experts lawyers etc.

The rights of the company auditor cannot be limited or reduced by passing any resolution limiting the powers through articles of association.

**Conclusion**

The audit of a joint stock companies is statutory. The companies act 1956, contains specific provisions relating to the auditor appointment duties etc., section 226(2) states only charted accounts or certified auditor are qualified for appointment as auditor. Section 226(3) states that a person may be disqualified from becoming an auditor in certain cases section 224. States that the Board of Director, shareholders and Central Government are empowered to appoint auditor. The auditor may be removed at the general meeting with the approval of central government. The appointing authority is authorized to fix auditor remuneration section 227 states that as the agent of the shareholders. The duty of the auditor includes making a report on the financial position, to sigh the audit report to certify statutory report and prospectus to assist investigator etc.

The auditor is entrusted with a right to access the books and accounts, to obtain information to receive notice of and the general meeting etc.

**Short Answer Type Questions**

1. What is meant by Auditors remuneration?
2. What is Audit Report?

**Long Answer Type Questions**

1. What is the procedure for payment of Remuneration of an auditor?
2. What are the duties of an auditor?
3. Explain the rights and power of an auditor.
7.1 Meaning of vouching

Vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It is the essence of Auditing.

It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which
the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. Vouching does not include valuation.

Vouching can be described as the essence or backbone of auditing. The success of an audit depends on the thoroughness with which vouching is done. After entering in all vouchers, only then can auditing start. Vouching is defined as the “verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc.

7.2 Objects and importance of vouching

The object of vouching is to establish that the transactions recorded in the books of accounts are (1) in order and have been properly authorized and (2) are correctly recorded. “Simple routine checking cannot establish the same accuracy that vouching can. In routine checking, entries recorded in the books only show what information the bookkeeper chooses to disclose, however these entries can be fictitious without any vouching or vouchers. By using a vouching or a voucher system a company will have concrete and solid documentation and evidence of expenses, capital, and written proof in audits. Vouching is the essence or backbone of auditing because when performing an audit, an auditor must have proof of all transactions. Without the proof provided by vouching, the claims provided by the auditor are just that, only claims.

In most cases, hard to detect frauds can only be discovered through the use of vouching. This means that the auditor must conduct vouching with great importance, if not, he can be charged with negligence which happened in the case of Armitage v. Brewer and Knott. Through this case, the importance of vouching was realized. In this case, the auditors were found to be guilty on negligence, because the auditors did not display enough reasonable care and skill in vouching the wage sheets and ended up failing to detect fraud in manipulation of these wage records and cash vouchers. When delivering the decision the Judge stated that “It was clear that a good many documents were suspicious o neither face and called for Inquiry”. It was declared that it was essential that due care and attention are to be given to vouching in auditing.

Importance of Vouching

Vouching is the act of checking evidential documents to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. Thus, it is important for an auditor due to the following reasons:
1. Vouching is the backbone of Auditing

Main aim of auditing is to detect errors and frauds for proving the true and fairness of results presented by income statement and balance sheet. Vouching is only the way of detecting all sorts of errors and planned frauds. So, it is the backbone of auditing.

2. Vouching is the essence of Auditing

Auditing not only checks the accuracy of books of accounts but also checks whether the transactions are related to business or not. All the transactions are performed after the prior approval of concerned authority or not, transactions are real or not because an accountant may include fictitious transactions to commit frauds. All these facts can be found with the help of vouching. So, vouching is essential for auditing.

3. Vouching is important to see whether evidences are correct or not

An auditor checks the books of accounts to detect errors and frauds. Frauds may be committed presenting duplicate vouchers. All the small and big amounts of frauds can be detected with the help of vouching. So, all the evidential documents and records are to be checked carefully and in detail by an auditor which is the scope of vouching.

Therefore, it can be said that vouching is the heart of auditing because without the work of vouching, the work of auditing cannot be performed.

7.3 Measures to be taken for vouching

Vouching helps to prove the truth and fairness of account by detecting errors and frauds. So, while conducting the test of vouchers, following factors are to be taken into consideration.

1. An auditor should check the records whether they are supported by evidential documents or not.

2. All the documents related to income and expenditures are to be separated and separate files should be maintained. If not, auditor should ask to do so.

3. An auditor should use special sign in tested vouchers so that they cannot be used again.

4. While vouching, an auditor should check whether the general principles of accounting have been followed or not and clear cut demarcation of capital and revenue is made or not.
5. Whether the documents presented for testing are related to the current year or not.

6. All the documents which are presented for auditing must be authorized by the concerned authority. An auditor should check whether it is done or not.

7. An auditor should ask duplicate copies of missing vouchers, but if important vouchers have been missed and auditor is not satisfied with the reasons presented, s/he should write in report to this fact.

8. If an auditor finds the correction in the evidential document, then such figures should be verified with documents and to be noted down in audit note book for consideration while preparing report.

9. All the documents are to be reviewed before closing the work of audit which helps to check again those facts where special sign is given.

### 7.4 Meaning of error and fraud

Error is a mistake a raised due to an involuntary act and most of the error are of innocent nature. Certain error may be committed purposefully in order to conceal some fraud already committed. The errors are committed due to the human element present in the work. Now-a-days errors also occur due to defects in the operations of mechanical devices like calculators, computer, etc., or wrong coding of messages used for accounting of the transaction.

Even the machine is controlled by human beings. Normally, those errors affect the correctness of the accounts. The auditors, being very careful in examination of the books of accounts can easily detect the errors. Routine checking helps him to find easily detect the error. Routine checking helps him to find out errors in totaling, posting, forward etc.

**Definition of Error**: According to Dinkar Pagare, “an error may be defined as any unintentional mistake or misdescription in the books of accounts or records whether by way of (a) mathematics or clerical mistakes in the records and data; (b) Oversight or misinterpretation of facts; or (c) misapplication of accounting policies”.

Thus an error is taken to be ab unintentional mistake committed in the books of accounts or records, But, where an error appears to be deliberately made, it assumes the character of a fraud.
**Definition and Meaning of Fraud**

Fraud is the word used to mean an intensional error, R.K. Mautz has included fraud in the broad category of errors, as the error is an involuntarily act where as fraud is a deliberate act committed against proprietors, government, people etc. Fraud implies dishonesty with a motive to device, to mislead, or at least to conceal the truth. Thus fraud is considered more dangerous than errors.

**Definition of Fraud**

Fraud is really a false representation or entry which is made always intentionally with some mischievous objects.

### 7.5 Types of errors and frauds

The errors may be divided under four categories viz.

1. **(a) Clerical Errors.** These errors may be subdivided into,
   1. (i) Error of omission and
   2. (ii) Error of Commission

2. **(b) Error of Principle**

3. **(c) Compensating errors and**

4. **(d) Errors and Duplication.**

   **(a) Clerical Error :** A clerical error may occur while entering the transactions in the journal or subsidiary books, or while making postings into the ledger; or while balancing ledger accounts, or while transferring the balances to the trial balance.

   **(i) Error of Omission :** The error of omission is one where a transaction has not been recorded in the books of accounts, either wholly or partially unrecorded.

   **(ii) Errors of Commission :** An error of commission takes place when a transaction has been entered in the books of original entry or in the ledger, either wholly or partially. Such mistake arises due to incorrect postings, casting, carry forwards, calculation, balancing, extensions etc.

   **(b) Error of Principle :** Errors of principle arise when the entries are not recorded according to the fundamental principles of accountancy. Such errors may be committed either intentionally or unintentionally.

   **(c) Compensating Errors :** A compensating error is one, which is counter balanced whether wholly or partially by any other errors series of errors. They are also known as off setting errors.
(d) **Errors of Duplication**: Such errors arise when a transaction is entered twice in the books of original entry and posted twice to the concerned ledger accounts.

**Types of Fraud**

A great variety of frauds may be found, but the following are the chief ways may be committed.

(a) Misappropriation of Cash.

(b) Misappropriation of goods, and

(c) Manipulation of Accounts

(a) **Misappropriation of cash**: Means fraudulently using the money of the business for one’s own use. This can be done by inflating cash payments, by suppressing cash receipts, by casting wrong totals on cashbook, and also by embezzlement of cash. It is easier to misappropriate cash. There is greater possibility of misappropriation of cash in a big business house than in the case of sole trading concern where the proprieiter has a direct control over the cash receipts and payments.

The cash may be misappropriate in any of the following way

(a) Adjusting fictitious rebates, allowance, discounts, bad debts, etc., to customer’s accounts.

(b) Not accounting for miscellaneous receipts like sale of scrap and substandard goods, rent on quarters allotted to the employees, etc.

(c) Not accounting cash sales.

(d) Teeming and lading which means concealment of a shortage by denying the recording of cash receipts.

(e) Making payments against fictitious vouchers or against inflated vouchers i.e, entering more amount than what has been paid.

(f) Writing down assets value fully, and selling them subsequently.

(g) Non-recording of Credit Notes for purchase returns..

(h) Non-recording of Credit of bills discounted.

(i) Non-recording of unusual receipts such as perquisites, donations, gifts etc..

(j) Manipulating totals of wage rolls by including the names of dummy workers.
(k) Entering less amount in the cash book than what has been actually received.
(l) Entering cash received from one customer against another.
(m) Recording payments, which were never made.
(n) Cash thefts, etc.

The auditors has to pay particulars attention towards cash transaction at the time of vouching. A sound internal check system as regards cash receipts and payments minimizes the possibilities of misappropriation of cash. He should carefully compare the entries in the cashbook with those in the Rough Cashbook. He should check the receipts side of the cash book with the salesmen reports, the agents returned, counter foils or carbon copies of the cash receipts book and other original entries. He should check the payment side of the cash book with original evidence in the form of voucher, invoices, salary register wage sheets, etc. He should obtain confirmatory statements of balance from the debtors and creditor. The vouching of cashbook is more detailed in the fifth chapter.

(b) Misappropriation of Goods: Misappropriation of goods refers to the use of the goods of the business for purpose other than that of enterprise. They are in the nature of theft. Generally goods that are less bulky and more valuable are misappropriated. For example the components of a time watch are less bulky of higher value. It is easy to carry them secretly without fear.

Such frauds may be committed by way of recording purchases of smaller quantities than are actually received, or entering sales of larger quantities than are actually supplied. The balance quantity is misappropriated for unlawful personal benefit.

This type of fraud is very difficult to detect where stores accounts are not maintained properly. The misappropriation of goods will be less when the enterprise maintains a perfect inventory control and physical verification of stock. An efficient internal check system with regards to sales an purchase of goods also avoids such frauds. The auditor has to verify Stock Register, Purchase Book, Sales Book, Goods Inward Book and Goods Outwards Book. Periodical comparison of the percentage of Gross profit/sale ratio will indicate the loss of stock. He has to make frequent check on incoming and outgoing of goods.

(c) Manipulation of Accounts: Fraud by means of manipulations or falsification of accounts and financial statements may be committed without any misappropriation of cash or goods. Often, these frauds are committed by the management. The object of committing these frauds may be overstate profits, to understate profits, or window dressing.
(a) The profit may be overstated for the following reasons
i. To get more commission on profits
ii. To declare higher rate of dividend on shares
iii. To push up the prices of the shares held by the directors
iv. To maintain confidence of the share holders
v. To secure better credit facilities
vi. To attract prospective investors etc.

(b) The profits may be understated for the following reasons.
i. To reduce or avoid the taxes
ii. To discourage competitors to enter the industry.
iii. To avoid payments of higher bonus to the workers.
iv. To induce a fall in share prices so as to acquire shares in bulk etc.

(c) Window Dressing
Window dressing means preparing the balance sheet in such a way as to display financial position of the undertaking less or more than the actual position. There are numerous ways of committing falsification of accounts.

Short Answer Type Questions
1. Define vouching.
2. What is an Error?
3. What is meant by fraud?
4. What is misappropriation of cash?
5. What is misappropriation of goods.
6. Define window Dressing.

Long Answer Type Questions
1. Explain the objects of vouching.
2. Explain the importance of Vouching.
3. What are the measures to be taken for vouching?
4. Explain different types of Errors.
5. Explain different types of Frauds.
8.1 Meaning of investigation

Investigation is the act of detail examination of activities so as to achieve certain objectives. Specially, investigation is made in suspected places. It finds out the nature and reasons of suspected areas but auditing is the act of examining books of accounts so as to prove true and fairness of operating results and financial position of a business.

Nature of Investigation

Investigation is an enquiry into the financial statements of a number of past years with a view to know the real financial position or earning capacity. It is in fact a kind of special audit with predetermined scope depending upon the purpose to be achieved. Investigation is neither accounting nor auditing.
Investigation is carried out not in substitution of audit, but in addition to audit. The investigating auditor may even have to investigate the audited accounts.

**Scope of investigation**

No general principle can be laid down with regard to the scope of every type of investigation. Scope of investigation, in each case, would be limited to the period or area to be covered by the investigator.

An investigation on behalf of a person intending to purchase running business of a sole trader will be restricted to the determination of value of assets, liabilities, reserves, existing potential and future prospects. An investigation to settle suspected irregularities in cash or stock would normally cover a period from three to six months.

**Objectives of Investigation**

The real objective of conducting an investigation by an auditor on behalf of his client is to provide him the desired information in the form of a report about the matter specified. Normally the objective of investigation is to collect, analyze and evaluate facts in respect of desired field of activity with a view on some special purpose as determined by the person on whose behalf the investigation is undertaken. In short investigation is to ascertain the financial position and earning capacity of a business on behalf of a certain person.

**The common objectives of investigation are listed below**

1. Proposed purchase of business.
2. Proposed sale of business.
4. Cause of high employee turn over.
5. Reliability of business data.
6. Proposed investment in particular securities.
7. Suspected fraud.
8. Joining in existing partnership business.
10. Lending funds.
11. Proposed purchase of controlling shares in a company.
12. Suspected misfeasance against directors.
14. Suspected misappropriation by trustees.

8.2 Differences between auditing and investigation

1. Legal binding

Audit of annual financial statements is compulsory under the Companies Ordinance, 1984. Investigation is not compulsory under Companies Ordinance but voluntary depending upon necessity.

2. Object in view

Audit is conducted to ascertain whether the financial statements show a true and fair view.

Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc.

3. Period covered

Audit is conducted on annual basis.

Investigation may be conducted for several years at a time, say three years.

4. Parties for whom conducted

Audit is conducted on behalf of shareholders (or proprietor, or partners).

Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc.

5. Documents

Audit is not carried out of audited financial statements.

Investigation may be conducted even though the accounts have been audited.

6. Extent of work

Audit is normally conducted on test verification basis.

Investigation is a thorough examination of books of accounts.

7. Report

Audit report is addressed to shareholders (or proprietors or partners).

Investigation report is addressed to the party on whose instruction
investigation was conducted.

8. Adjustment in net profit

In case of audit net profit disclosed by audited accounts is final without further adjustments.

In case of investigation in order to determine real earnings certain adjustments are always essential.

9. Person performing work

Audit is to be conducted by a chartered accountant.

Investigation may be undertaken even by a non-chartered accountant.

8.3 Circumstances investigation conducted

1. Investigation on behalf of a purchaser, to ascertain the earning capacity of the concern and whether the assets have been properly valued.

The investigator should pay attention to the following points when called upon by his client who wishes to purchase a running business top conduct an investigation.

1. Why does the vendor sell the business? Is it a genuine case of sale?

2. Whether it is worthwhile to purchase the business?

3. What is the trend of the business? This may be known by preparing a columnar statement for the past several years, showing the expenses, sales, gross profits, net profits, and the percentage of their rise or fall to show whether the business is on the road to prosperity.

2. Investigation on behalf of a Lender of Money

Sometimes a bank is asked by its customer to lend him heavy amount or allow an overdraft or the pay bills even though his credit balance may be insufficient. Hence, the bank should like to know the financial position of the borrower; it may not be in a position to know the true financial position and may hesitate to lend money especially when the amount involved is a heavy one. Under such circumstances the bank may requisition the services of an investigator before it grants the necessary loan.

3. Investigation when Fraud is suspected

When the investigator is called upon an investigate into a suspected fraud. He should study the system of accountancy and internal check followed in the business. If he finds that there is any loophole and there is a possibility of
fraud, he must go deep into the question. It is very difficult to lay down the
different methods of fraud as human ingenuity has and will ever devise various
and peculiar ways to commit fraud. Each case must be handled on its own
merits. But it must be remembered that fraud is usually committed by those who
handle cash and goods. Fraud may also be committed by manipulating the
accounts. Thus fraud is usually committed in the following ways:-

(a) By misappropriating cash — (usually committed by the employees).
(b) By misappropriating goods — (committed by the employees).
(c) By manipulating the accounts — (committed by the proprietors or
those at the helm of affairs).

(a) Misappropriation of Cash
Cash may be misappropriated in any of the following ways
1. Omitting to enter the receipt of cash.
2. Entering less amount in the cash book than what has been received.
3. Entering fictitious payments.
4. Entering more amount than what has actually been paid.

(b) Misappropriation of Goods
Pilfering of goods is very difficult to detect especially when they are
small in bulk and are very costly. Proper stock accounts should be maintained.
The Investigator should check the receipt and issue of goods and the stock
Accounts. He should compare the Order Received Book, Sales Book, Gate-
keeper’s Book and invoices, etc.

(c) Manipulation of Accounts
Accounts may be manipulated by (a) the proprietors of a business, (b)
the partners of a firm, (c) the employees, or (d) the directors of a company. The
object of manipulation of accounts may be to
1. Show less profits in order to pay less income tax;
2. Show more profits to earn more commission. If it is payable to the
manager, employees, etc., on the result of the rate of dividends.
3. Show more profits than actually they are in order to maintain the rate
of dividends.
4. Show more profits when the business is going to be sold.
4. Investigation on behalf to a client who wishes to purchase the shares of a company

The subject of valuation of shares has always been controversial in the accounting profession. There are people who are of opinion that there is no scientific method of valuation of shares of a company, but it is a wrong notion.

**Duties of the Investigators**

If an auditor is appointed under the above circumstances to conduct an investigation, he should get instructions in writing regarding the scope of enquiry, its objects and the time limit by which the report has to be submitted. The auditor so appointed should proceed on the following lines.

1. Whether there has been any breach of duty by any officer.
2. Whether any loss has been caused by the negligence on the part of directors, etc.
3. Whether contracts entered into were fair deals especially those entered into with directors and officers of the company.
4. Whether the assets and liabilities have been properly valued. He should also verify them.
5. He should interrogate directors and officers of the company, and if need be, he may seek legal advice. He may, if he thinks necessary, interrogate directors and officers of related companies.
6. If there are subsidiaries, he should direct his attention to the inter-company dealings.

**Short Answer Type Questions**

1. What is investigation?
2. What is meant by Audit Report?
3. Define scope of Investigation.
4. What is the nature of Investigation?

**Long Answer Type Questions**

1. What are the objects of investigation? Explain.
2. Explain the difference between Auditing & Investigation.