# Auditing

tutorialspoint

SIMPLY EASY LEARNING

www.tutorialspoint.com

https://www.facebook.com/tutorialspointindia

https://twitter.com/tutorialspoint

## About the Tutorial

The main objective of auditing is to ensure the financial reliability of any organization. Independent opinion and judgment form the objectives of auditing. Auditing also helps to ensure that the books of accounts are kept according to the rules stipulated in the Companies Act and whether the books of accounts show a true and fair view of the state of affairs of the company or not.

## Audience

This tutorial has been prepared for all those readers who wish to have a quick overview of how auditing works and helps organizations in diverse fields.

## Prerequisites

To understand this tutorial, you need to be familiar with the basics of accounting at workplace.

## Copyright & Disclaimer

# Table of Contents

# 1. AUDITING – INTRODUCTION

The origin of auditing can be traced to Italy. Around the year 1494, Luca Paciolo introduced the double entry system of bookkeeping and described the duties and responsibilities of an Auditor.

Auditing in India has been described in different ways:

> "Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the Auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report."

**- The Institute of Chartered Accountant of India**

Another definition goes as such:

> "Auditing is an intelligent and critical scrutiny of books of accounts of a business with the documents and vouchers from which they have been written up, for the purpose of ascertaining whether the working results of a particular period as shown by Profit and Loss Account and also the financial position as reflected in the Balance-sheet are truly and fairly determined and presented by those responsible for their compilation."

**- J. R. Batliboi**

## Auditing in India

Let us now understand the growth of auditing in India. The Indian Companies Act, 1913, prescribed for the first time the qualifications of an Auditor. The Government of Bombay was the first to conduct related courses of study such as the Government Diploma in Accountancy (GDA).

The Auditor's Certificate Rule was passed in 1932 to maintain uniform standard in Accountancy and Auditing. The Chartered Accountant Act was enacted by the Parliament of India in 1939. The Act regulates that a person can be authorized to audit only when he qualifies in the examinations conducted by The Institute of Chartered Accountants of India.

Following are a few other points related to Auditing in India:

- Members of Institute of Cost and Works Accountant of India are authorized to conduct cost audit according to Section 233-B of the Companies Act, 1956.
- Companies Act 1931 was replaced by Companies Act 1956.
- An Auditor can be appointed only by a special resolution as per section 224 The Companies (amendment) Act, 1974.

## Bookkeeping

A Bookkeeper records day-to-day transaction in the books of accounts in a systematic manner. Bookkeeping includes:

- Journalizing
- Posting to ledger
- Totaling and balancing of ledger accounts

## Accountancy

The job of Accountancy begins where bookkeeping ends and includes the following;

- Rectification of errors
- 
- Preparation of Trial Balance
- 
- Preparation of financial statements (Trading and Profit & Loss account and Balance-Sheet, etc.)

## Auditing

Preparation of accounts is not the duty of an Auditor. “Auditing begins, where accountancy ends”. Auditor is only concerned for checking and verification of records. Auditor is a qualified person appointed for the purpose of certification of work done by others.

## Investigation

An investigation may be done with a specific purpose. It is usually conducted to know the financial position of a business, extent of fraud and misappropriation and the earning capacity of any business unit, etc. The time duration for investigation may also extend beyond one year. Investigation may not be necessarily done by a qualified Chartered Accountant.

## Qualities of an Auditor

An Auditor must have the following qualifications and qualities:

- He should be a qualified Chartered Accountant or he should be a qualified member of The Institute of Cost & Works Accountants of India to do cost audit.
- 
- He must have adequate skills and qualities to conduct his work efficiently.

- An Auditor must be honest, impartial and unbiased. He should also be hardworking, have adequate common sense, capacity to hear arguments of others, systematic and methodical.
- An Auditor should ask for clarification on matter on which he is unable to understand the information provided to him.
- His audit report should be correct and clear.
- In case where any suspicious situation arises, he should assume that he is dealing with dishonest and fraudulent peoples.
- He must have thorough knowledge of accounting principles and practices.
- He must have the knowhow of all the domestic and international court case decisions.
- He must have thorough knowledge of financial management, industrial management and business organizations.
- He must have up-to-date knowledge of the Mercantile law and the Companies Act.

## Scope of Auditing

In comparison with earlier days, where the main objective of auditing was to detect fraud, we now have enhanced ways to determine a true and fair view of financial statements. In recent times, almost every country of the world has introduced various legislations and framed rules and regulation of auditing. In India also legislations related to Tax Audit, Cost Audit, Management Audit and operation Audit, etc. are coming up.

The main purpose of auditing is to certify the correctness of financial statements and to detect errors and frauds.

## Techniques of Auditing

Following are the common techniques of auditing:

- Checking of posting and casting.
- Physical verification of assets.
- Verification and examination of transactions with available evidences.
- Scrutiny of the books of accounts.
- Checking of various calculations.
- Checking of carried forward balances in next year.
- Checking of Bank reconciliation statements.
- Auditor can get information from inside and outside sources of organization.

# Auditing – Fundamentals

# 2. AUDITING – DETECTION AND PREVENTION OF FRAUD

The main objective of auditing is to ensure the financial reliability of any organization; detection of fraud is just an incidental object.

Independent opinion and judgment form the objectives of auditing. The job of an Auditor is to ensure that the books of accounts are kept according to the rules stipulated in the Companies Act; an Auditor also needs to ensure whether the books of accounts show a true and fair view of the state of affairs of the company or not.

The following are the three distinct types of fraud:

- Misappropriation of Cash
- Misappropriation of Goods
- Manipulation of Accounts

## Misappropriation of Cash

Misappropriation of cash is the easiest way of fraud especially in large business houses where there is limited or no communication between the owner of an organization and the cashier. Following are some of the ways through which embezzlement or misappropriation can be done:

- Theft of cash receipts and petty cash and showing fictitious payment to workers, creditors, purchases, etc.
- Showing false payments or excess payments in cash book.
- By using the **Teeming and Lading** method, the money received from any customer can be pocketed and the money received from another customer can be shown as money received from the former.
- Cash sale can be shown as credit sale.

Strict internal control system should be followed in receipts and payments of cash so that the work done by one person should be automatically checked by another person.

## Misappropriation of Goods

Misappropriation of goods can be done in the following ways:

- Goods may be stolen by employees or with the help of employees.
- By issuing false credit notes to customer on account of goods return.

Detection of misappropriation of goods is more difficult rather than detecting misappropriation of money, especially where management is not much vigilant and sound system of book-keeping, internal control and adequate system of securities are not available. To keep control on the physical verification of goods, reconciliation of physical stock with books and careful checking of sale and purchase is must.

## Manipulation of Accounts

Two types of manipulation of accounts are mainly done by top management to mislead some parties for some specific purpose.

- **Showing higher profits**: Following are the reasons behind showing higher profit than actual:
    - To obtain credit or to enhance existing credit from financial institutions and also to show credit worthies to suppliers of the company.
    - To maintain confidence of shareholders.
    - To hike the market price of shares of the company and enable the sale of those at higher price, it may be done by declaring higher dividends on shares.
    - To get more commission where commission is calculated on the basis of profit earned.
    - To declare dividend at higher rate.
- **Showing low profits**: Following are the reasons behind showing lower profit than actual:
    - To avoid or to reduce Direct Taxes of the company (Income Tax, Wealth Tax).
    - To purchase shares at lower price.
    - To give wrong impression to the other competitors of the business.

## Manner of Manipulation of Accounts

Manipulation of accounts may be done in the following ways:

- **Window dressing** is a manipulation or miss-representation of financial data in such a way that it seems better than what it actually is. Some of the method of window dressing is given as hereunder
    - Over valuation of closing stock
    - Under valuation of Liabilities or Over-valuation of assets.
    - Purchases and expenses of current year may be deferred to next financial year.

- Charging revenue expenses as capital expenditure
- Sale and other incomes of preceding year may be shown as income or sale of the current year.

- Secret reserves of previous years may be used in the current financial year to inflate the profit or secret reserves may be created to suppress the profit of the current financial year.

- Stock may be under or overvalued. Income and sales may be suppressed or inflated. Expenses and purchases may be suppressed or inflated.

End of ebook preview
If you liked what you saw…
Buy it from our store @ **https://store.tutorialspoint.com**