PRINCIPLES OF AUDITING

Dr. R. Francis

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Dedicated to

Sri V. Rajamony and Smt. K. Palammal

Mr. R. Austin Raj and
Adv. R. Ranjith Singh

Founders of R.P.A. College of Education & R.P.A. Central School, R.P. Nagar, Mamoottukadai, Kanyakumari District, South India.

Auditing is the science which deals with the verification of financial and non-financial records maintained in any concern.

– Dr. R. Francis

PREFACE

Auditing is an important purposeful activity from the legal, economic, social, political and ethical point of view especially in the business world. It is not an ordinary work or activity. In fact, it is based on certain principles. Hence, the knowledge of auditing is essential for all who engage in any business or run any institution.

The book, *Principles of Auditing,* is intended for the graduate and postgraduate students of Commerce of all Indian universities. This is a comprehensive book that provides all the topics in detail so as to help the teachers and students grasp the subject matter easily. And it also meets the requirement of those who appear for competitive examinations like CA and ICWA. It is a book of new approach which deals with the special auditing of hospitals and educational institutions. In fact, it contains almost all subject matters prescribed in the Indian universities. Moreover, the simplicity of language and systematic approach enable the teachers and students to prepare for examinations, assignment, discussion and seminar. Above all, this is one of the best books available in the market because it deals the subject with practical experiences.

The salient features of this book are: (1) It discusses the the new trends in auditing, (2) It highlights the problems of auditing, (3) It provides suggestions for making the auditing process effective and successful, (4) It meets the requirements of students of all categories, (5) It provides review questions and references which enable the learners to acquire a comprehensive knowledge in the auditing field. Therefore, this book can be used as text as well as reference one.

– Dr. R. Francis

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– Dr. R. Francis

CONTENTS

1.	Meaning and Nature of Auditing	1 – 27
2.	Principles and Planning of Auditing	28 – 40
3.	Audit Programme	41 – 52
4.	Auditing in EDP Environment	53 – 63
5.	Audit Evidence and Audit Procedures	64 – 79
6.	Internal Control and Internal Checking	80 – 95
7.	Vouching and Routine Checking	96 – 118
8.	Verification of Assets and Liabilities	119 – 139
9.	Investigation	140 – 158
10.	Capital and Revenue	159 – 164
11.	Depreciation	165 – 175
12.	Reserves and Provisions	176 – 185
13.	Management Audit	186 – 196
14.	Cost Audit	197 – 211
15.	Tax Audit	212 – 219
16.	Audit of Government	220 – 228
17.	Divisible Profit	229 – 247
18.	Audit of Financial Statement	248 – 275
19.	Audit of Limited Company	276 – 298
20.	Audit of Insurance Companies	299 – 312
21.	Audit of Co-operative Banks	313 – 322
22.	Special Auditing	323 – 344
23.	Auditor's Report	345 – 356
24.	Professional Conduct and Ethics	357 – 381
25.	New Trends in Auditing	382 – 388
	Books for Reference	389 – 389
	Index	390 – 396

CHAPTER 1

Meaning and Nature of Auditing

Introduction

The study of principles and practices of auditing is important in the materialistic society. In fact, auditing has become an integral part of any business. It plays a vital role in the government and non-government organisations, institutions, industries and any concerns. This is because it not only helps to maintain the records related to finance and material accounts but also find out the errors and frauds in it. So, maintaining records is essential in all respects to make the concern confidential and successful one.

Meaning and Nature of Auditing

The word 'Audit' is derived from the Latin word '*Audire*' which means to hear. In olden days, some experienced people judged the account of business for the purpose of its correctness. For this purpose, they heard the accounts of the business people. Such persons are known as 'auditors'. As such, audit is the examination and verification of the books and records of a business. It enables the auditor to determine the accuracy and reliability of accounting statements and reports. In short, auditing is concerned with verification of accounting and financial records with a view to determine their accuracy and reliability. Therefore, it plays an important role in any business like industrial, educational, medical and banking institutions.

Origin of Auditing

Historically, it is understood that Luca Paciolo published the double-entry bookkeeping principles in 1949 at Venice in Italy. The accounts maintained under the double-entry bookkeeping principles include the records of all mercantile transactions. So, the scope of auditing automatically increased thereafter. Luca Paciolo also defined and described the duties and responsibilities of an auditor. Subsequently, the duties and responsibilities of an auditor have enormously increased in the commercialised society.

Moreover, the industrial revolution of England was another landmark in the history of trade and commerce. This led to a great increase in the volume of trading operations. Consequently, big enterprises such as partnership firms and joint stock companies realised that their interests could be well protected by an independent and impartial auditing. Further, the Institute of Charted Accountants in England was incorporated by Royal Charter on May 1880 with the sole purpose of preparing auditors. A professional auditing was introduced in the United States in 1990 to ascertain the actual financial condition and earning of an enterprise. It was the main aim and objective of auditing. The British Association of Accountants and Auditors was established in 1923. A person passing his examination from this association could be fully competent to work as a professional auditor. After a few years, an Accountancy Board was started in 1932. Moreover, Charted Accountants Act was passed in 1949. According to this Act, the entire management and control of the accounting profession is vested with the members of the professions.

Definition of Auditing

Spicer and Pegler have given the most commonly accepted definition of auditing. According to them, "An auditing is an such examination of the books, accounts and vouchers of a business, as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business and whether the profit and loss account gives a true and fair view of profit and loss for the financial period according to the best of his information and explanation given to him and as shown by the books, and if not, in what respect he is not satisfied."

F.R.M. de Paula agrees with Spicer and Pegler to a great extent and asserts that "Auditing denotes sometimes much wider, namely the examination of a balance sheet and profit and loss account prepared by others". As a result of his examination of the books, accounts, vouchers, etc. and of his inquiries, the auditors must satisfy himself that such balance sheet and profit and loss account are properly drawn up so as to exhibit true and fair view of the state of the affairs and of the earnings of a particular concern.

Reynold A. Irish has defined as "Auditing in its modern concept is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the balance sheet and the net income revealed by the profit and loss account".

According to Montgomery, a leading American accountant, 'Auditing is a systematic examination of the books and records of a business or other organisations, in order to ascertain or verify and to report upon, the facts regarding its financial operations and the results thereof".

Thus, the concept and scope of auditing have been changed considerably with the enlargement of size and complexity of business enterprises. A comprehensive definition relevant to the modern business world has been given by Robert E. Sholosser. According to him, "Auditing is a systematic examination of financial statement, records and related operations to determine adherence to generally accepted accounting principles, management policies or stated requirements". Thus, it lays emphasis on the point that auditing does not simply involve the examination of financial statement and records but also related operations. It has also to be seen as to how far they adhere to management policies or stated requirements. Thus, it reflects the modern trend of auditing and points out that its scope has enlarged considerably.

According to the above definitions, it is understood that the auditing is the verification of account books of a concern. However, it is important to note that auditing is carried on in a scientific and systematic manner. In fact, the technique of auditing is based on scientific principles. It is not carried on haphazardly and is conducted by persons who are technically qualified and fully experienced in the job of examining the books of account of various types of concerns. It is not simply a mechanical comparison of accounting records with certain pre-determined objectives, testing their reliability and competency, and finding out adequacy of evidences of those records. So, it involves thorough examination which is essentially retrospective and analytical. The record which has to be examined is not prepared by the auditor. If he does it, he acts as an accountant then the audit is carried on regularly or periodically. Generally, it is done after the final accounts have already been prepared and thus, it may be half-yearly or annually. However, a big concern may even get it done throughout the year.

The auditor should satisfy himself as to the truth and fairness of the statement of financial affairs of the business. He should give report honestly to the owner of the concern. Therefore, his integrity, honesty and independence are essential, otherwise the very purpose of auditing may be defeated. That is why, he examined the books of accounts and checks their arithmetical accuracy. He should also ascertain the various policies as regards the operation and control of concern and how far they have been carried out by the management and to what extent the accounts reflect them. He should form opinion as to the ability of financial statement to convey the meaning of what they purpose to stand for.

The auditor should carry on auditing as thoroughly as possible. The extent of thoroughness would depend upon the individual circumstances of each case and he will have to exercise his own discretion for the same. One more point which should be borne in mind is that auditing is not confined only to the business organisations as has been emphasised by various authors on the subject. It may be necessitated by any economic unit. There are numerous non-business organisations, for example, educational institutions, religious and charitable institutions which get their accounts audited regularly by professional auditors in the modern society.

This procedure will be changed when the auditors and their client feel that financial auditing would not serve the purpose for which the auditing has to be carried out. Therefore, its scope and objectives should be enlarged further with change in the attitude of the society, the management and the government. Therefore, the tools and techniques of auditing would have to be changed and improved according to the needs of the circumstances. Hence, the auditors should think over it and do the needful in this area.

Elements or Features of Auditing

Generally, the process of auditing has certain characteristics as given below:

1. It is a thorough, systematic and analytical examination of the counting records of the client, for instance, organisations and institutions.
2. The accounts should be prepared by other, and not by auditor.
3. The examination of accounting records may be made throughout the year or periodically according to the circumstances.
4. The auditing should be carried on independently by duly qualified person.
5. The auditor should examine the accounting records with the help of relevant records, vouchers documents, information and explanation, etc., following accepted tools and techniques of auditing.
6. The auditors should satisfy himself and report with regard to the truth and fairness of the profit or loss of the period and financial position of the concern, as reflected in its balance sheet.
7. The scope of auditing is not limited only to the business concerns, but it may be duly extended to non-commercial concerns also.
8. Thus, auditing is concerned with the latest developments in the business world and it is changing with the requirements. However, it emphasises upon the efficiency auditing, social auditing and systems auditing.
9. Auditing has become an important social responsibility of all businesses.

Need and Importance of Auditing

There are various factors influencing the need and importance of auditing. They are as given below:

1. **Industrial Revolution:** The Industrial Revolution brought about tremendous changes in the system of production and distribution, and with that, the organisation set-up of the business enterprises also advanced and changed tremendously. This also increased the size of enterprises enormously. The industrial revolution has brought about the change in the technique of auditing and detailed checking of all the accounting records. Moreover, it has changed the objectives of auditing. It causes the emergence of auditing as an independent profession in the materialistic society.
2. **Divorce of Ownership from Management:** As the size of the business enterprises grew, there has been a tendency for the divorce of ownership from the management. This necessitated a thorough checking of the records by independent auditor, so that the owners may be able to get the clear picture of the working of the concern managed by others.
3. **Regulation by the State:** The governments of all the States are regulating the concerns considerably to protect the interest of large number of investors. As a result, several Acts have been passed in our country from this point of view. For instance, Capital Issues Control Act, 1947, the Industries Development and Regulation Act, 1951 and the Companies Act, 1956, and the various labour and mercantile laws of the country have been passed at national level. These Acts have emphasised the auditing of the accounts of almost all commercial and non-commercial units.
4. **Pronouncements by Court of Law:** Judiciary has also influenced and helped the evolution of auditing considerably. In fact, the important judgements have been passed by the Court of Law which demanded a change in the attitude of the auditors. The law has made it easier for the aggrieved party to sue an auditor and make him responsible for negligence. Accordingly, the judgments demand judicial pronouncements for the establishments of generally accepted accounting principles and auditing standards. Thus, they are playing a very important role in bringing about necessary changes in the practices and standards adopted by the auditors.
5. **Mechanised Accounting:** There is a growing change in the techniques and practices of auditing in the technological world. In fact, the use of mechanisation, especially computers, is done for recording and maintaining the transactions in industries and institutions. Consequently, it has necessitated considerable changes and a rethinking on the part of auditors. So, they cannot entirely depend upon the traditional tools and techniques of auditing in the modern society.
6. **Regulation by Profession:** It is seen that the accounting profession is duly regulated in almost all countries. In our country, the Institute of Charted Accountants is making considerable efforts to evolve its own standards of education, training, professional expertise, ethics and discipline. In fact, it has a great influence on the growth of auditing.
7. **Establishment of International Accounting Standards:** Recently, efforts were taken to evolve international accounting standards. This would definitely be a hallmark in the evolution of auditing. This would bring about uniformity in practices followed by the auditors in various countries of the world. For this purpose, International Accounting Standards Committee was constituted. The Institute of Charted Accountants of India and the Institute of Cost and Works Accountants of India are associate members of the Committee. The standards laid down by the Committee would be applicable to all the member bodies of various countries, including the above institutes of India.

8. **Social Responsibilities:** The business concern was responsible only to its proprietor in the ancient periods. But it is accepted and recognised that a business owes its facts to the society in the modern society. This has also been an important factor for the enlargement of the duty of the auditor and much more is demanded from the auditor. So, it requires regular or routine auditing. In other words, every business concern should disclose its accounts/records to the government on demand.
9. **Emphasis upon Efficiency Audit:** Today, more and more emphasis is laid upon efficiency or propriety auditing rather than simply depending upon the regular auditing. A large number of government undertakings have been set up in the country and there is growing emphasis upon use of efficiency auditing in them so that they may fulfil the social responsibility more faithfully than anything else.
10. **Compulsory Audit of Certain Firms and Professions:** Recently, the government of India in the Budget of 1984, has introduced the compulsory auditing of accounts of firms whose annual turnover exceeds ` 20 lakhs and of professions whose annual gross receipts exceed ` 10 lakhs. This has enlarged the scope of auditing considerably. Thus, auditing has become one of the important activities in the modern society.

Auditing is a Luxury or Not

There are different views among the educationists and scholars whether auditing is a luxury or not. It is seen that some of them consider it as a luxury whereas others do not.

Auditing is a luxury: Following arguments prove that auditing is a luxury.

Auditing is a luxury, undoubtedly, for the smaller concerns as it is not necessary for them. But they can afford it, if they want it. No doubt that it is quite a luxury for small vendors, shopkeepers and vegetable or fruit sellers. Moreover it is luxury for those business concerns which cannot afford high cost of Auditing. If the income of a business concern is relatively lower, Auditing of its accounts would be a luxury.

It is also a luxury for such concerns where it results in unnecessary wastage of time, energy and money. In fact, auditing involves considerable time and money. And therefore, several concerns just cannot afford it. Further, auditing is a luxury one if it is undertaken merely to increase the prestige and credibility of the concern in the eyes of the business world even though they cannot afford it.

Audit is not luxury: Auditing may be a luxury for the relatively smaller concerns. In fact, it is not luxury at all for the majority of the business concerns or professionals. With the enlargement of their operations, it becomes quite necessary from the point of taxation getting loans, obtaining credit etc. Above all, auditing has been made compulsory if its annual turnover exceeds ` 20 lakhs.

Auditing helps to maintain a goodwill and mutual co-operation considerably among the partners. For professionals, auditing has not become part of their culture. However, there is growing consciousness on their part that they should also get their accounts duly audited to the satisfaction of the management and the government.

Accountancy and Auditing

Accountancy: Accountancy comes into the picture only when the bookkeeper has done his job. As accountant satisfy himself that the transactions have been properly recorded and posted in the books of accounts. He has to see whether the trial balance agrees and then prepare the profit and loss account and balance sheet after making necessary adjustments. An accountant is expected to be an expert in the accounting procedures as he should examine the final accounts.

Auditing: Usually, auditing begins where accountancy ends. Therefore, an auditor should verify the entries passed by the accountant and the final accounts prepared by him. Hence, auditing is the scrutiny of the report whether the balance sheet shows a true and fair view of the state of affairs of the business. We can distinguish accounts from auditing in the following grounds:

1. **Meaning:** Accountancy is concerned with the preparation of summary and analysis of records. On the other hand, auditing is the examination of the completed records.
2. **Employment:** An accountant is an employee of the business. But an auditor is an independent outsider.
3. **Remuneration:** As an employee, an accountant draws his monthly salary from the business whereas an auditor is paid a remuneration agreed upon between him and his client.
4. **Knowledge:** An accountant is not expected to have knowledge of auditing. On the other hand, an auditor should have proper knowledge in auditing. Moreover, may/can be changed from year to year.
5. **Purpose:** The purpose of accountancy is to measure business events in terms of profit or loss and communicate the financial condition of the business whereas, the purpose of auditing is to review the measurement and communicate the financial results.
6. **Report:** The accountant is not required to submit a report on the financial statement. But the auditor is required to submit a report on the financial statement.
7. **Status:** The accountant is an employee of the concern whereas an auditor is not an employee of the concern but he is an independent person from outside of the concern.
8. **Duration:** Accounting work is undertaken throughout the year but auditing is done at the end of financial year.

In this way, we can see the differences between auditing and accounting.

Auditing and Investigation

1. **Meaning:** Auditing is the examination of the completed records. On the other hand, investigation is an examination of accounts and records of a business concern with some special purpose in view.
2. **Purpose:** The purpose of auditing is to check whether the balance sheet of a concern is properly drawn up and exhibits a true and fair view of state of affairs. But investigation is done with some special purpose in view.
3. **Period:** Auditing is generally conducted at the end of a financial year and as such it relates to the accounts of one year only. At the same time, investigation covers several years to find out average earning capacity.
4. **For Whom:** Auditing is always conducted for proprietors only. On the other hand, investigation may be normally carried out on behalf of outsiders who wish to purchase the business or become partners and so on.
5. **Compulsion:** Auditing is legally compulsory specially in case of companies whereas, investigation is voluntary and depends upon the necessity of some purposes in view.

6. **Special Purpose:** Audited accounts are further investigated for some special purpose in view, whereas investigated accounts are not audited in the ordinary sense.
7. **Books of Accounts:** Auditing is limited to the books of accounts whereas, investigation goes beyond the books of accounts.
8. **Duties:** The duties of an auditor is stated in the Companies Act, 1956 whereas, the duties of an investigator depends upon agreement between the investigator and the client.
9. **Scope:** The scope of auditing is determined by the relevant laws whereas, the scope of investigation is limited as regards the period or areas to be covered.
10. **Audit Procedures:** Generally, accepted auditing procedures are adopted during the course of auditing. At the same time, extraordinary and extended auditing procedures are adopted during the course of investigation.
11. **Report:** Auditor's report is submitted to the shareholders. Such report provides the opinion of the auditor as regards the truth and fairness of the presentation in financial statements. Investigators report is submitted to the client who appoints him. The report is only a summarized conclusion of the investigator on the basis of the enquiry.

Differences Between Accountancy, Bookkeeping and Auditing

There are differences between accountancy, bookkeeping and auditing. Let us see them as given below:

1. Bookkeeping is the art of recording the business transaction in the books of original entry and ledgers.

   Accountancy is concerned with collection, classification, summarisation and communication of financial data.

   Auditing is concerned with analytical and critical examination of the financial records.
2. Bookkeeping involves only clerical work. Therefore, it doesn't require specialised knowledge. Auditing involves careful verification of books and records and to submit a report to the management. Therefore, it requires special knowledge in the particular field.
3. Accountancy begins where bookkeeping ends. Auditing begins where accountancy ends.
4. The bookkeeper and accountant are the employees of an enterprise. On the other hand, the auditor is an independent and professional competent outsider.
5. The bookkeeper and the accountant should record the transactions in the account books. The auditors should check and verify those transactions which are recorded in the books of accounts.
6. The bookkeeper and the accountant may or may not have the knowledge of auditing techniques and procedures whereas, an auditor must know the principles and techniques of accounting.
7. The bookkeeper and an accountant are the employees of the business and they work on a permanent basis. As far as the auditor is concerned, he is an independent and professionally competent outsider. So, he should be appointed every year.
8. The spadework is done by the bookkeeper and the accountant. But the final touch is given by the auditor.

Types of Auditing

Auditing may be classified into two types based on the coverage. From the point of coverage, it may be complete or partial auditing. A complete auditing is one in which all the transactions recorded in the books of accounts are audited thoroughly. On the other hand, a partial audit is one in which only a particular type of transaction is audited.

From the legal point of view, auditing may be voluntary or compulsory. A voluntary auditing is one which is carried on at the will of the proprietor of the concern. He may or may not get his accounts audited. On the other hand, the compulsory auditing is one which has been made compulsory under specific rules, and proprietors of the concern must get their accounts audited compulsorily. For instance, it is compulsory for all the companies to get their accounts duly audited under the Indian Companies Act, 1956.

On the basis of the nature of organisation, auditing may be by private or government auditors. The private auditing is one which is undertaken by the private organisations such as sole traders, partnership firms or joint stock companies. But government auditing is applicable to the government departments and undertakings. It is undertaken in a different way in both cases. It is important to note that auditing is also undertaken with specific objectives. On the basis of objectives, auditing may be cash auditing, special auditing, cost auditing, joint auditing, systems auditing or property auditing. Further, from the point of degree of independence, we may classify auditing into two classes, such as independent or statutory and internal auditing. Independent auditing or statutory auditing refers to the auditing undertaken in case of various businesses or other organisations independently by duly qualified auditors, mainly in accordance with the statutory provisions under certain Acts. On the other hand, the internal audit is undertaken by the employees of the concern, specially large in size. It is important to note that the internal auditing is neither compulsory nor undertaken by the duly qualified auditor under certain statutory provisions.

Final Auditing

A final auditing is one which begins after the close of the period of accounts. That is, it is carried on until it is completed. Thus, complete and detailed checking is done at one stretch. As such, it is not like the continuous auditing. It is also known as completed auditing. Periodical auditing or a balance sheet auditing. Sometimes, a differentiation is made between balance sheet auditing and final auditing. The balance sheet auditing is one which relates to examination of items of balance sheet alone. But the audit of items of the balance sheet cannot be carried out in isolation. It may be partially true in case the verification of assets and liabilities where auditing is carried out with some special objectives. The final auditing is the most satisfactory from the point of the auditor. As the full facts relating to the year under review are in his possession, he can carry on the auditing at a stretch until the whole work is over. However, he may not audit a comparatively bigger organisation. But the allocation of work among his staff may be done easily and judicially. Thus, system of auditing by his staff may be done easily and judicially. It is more suited to relatively smaller concerns and not to the giant concerns where transactions may be numerous. Moreover, it takes more time to complete the auditing of such huge concern and sometimes, it will be impossible to finish the auditing of the accounts within the limited time.

Advantages of Final Auditing

The main advantages of final auditing are as given below:

1. Auditing work can be completed easily. The auditor does not lose the thread of his work and maintains continuity.

2. It does not cause any dislocation of work of the client as the auditing is undertaken at the end of the year when accounting records related to that period are duly over.
3. Auditing work can be undertaken thoroughly and it does not become dull, monotonous or mechanical one.
4. It is convenient for the auditor also. As he need not maintain a large organisation, he can easily allocate his work of auditing among his staff.
5. The audit can be completed easily within reasonable time. This is because final auditing can be undertaken mechanically.
6. It helps in minimizing the collusion among the employees of the client and there is no question of alteration of the figures when the auditing work is over, as it happens in case of continuous auditing.

Disadvantages of Final Auditing

Final auditing has some limitations. Let us see them briefly as given below:

1. In case of final auditing, thorough and complete checking of all the accounting records is not possible. But it can be easily undertaken in case of continuous auditing.
2. It is not suitable for the organisation of the large size, where the transactions are numerous.
3. As auditor depends much upon test checking, errors and frauds can exist even after accounts have been audited.
4. It takes time to finalise the report in case of final auditing. Therefore, it is not suitable for the organisation which requires the report urgently.
5. It is not much effective in imposing moral check over the client's staff.

Continuous Auditing: It refers to a detailed examination of all the transaction by the auditor, continuously throughout the year or at regular intervals. For instance, it may be, say, fortnightly or monthly on fixed basis. Thus, the auditor visits the particular concern at regular or irregular intervals during the trading period and checks if the books are up to date, as far as possible. At the end of financial period, he should check the final accounts. Such type of auditing is also known as detailed auditing or running auditing. It is of great help to a relatively bigger concern. However, a continuous auditing is applicable in the cases given below:

1. Where it is necessary or desired to present the final accounts just at the close of the financial year.
2. Where a suitable system of internal check has not been applied and the chances for errors or frauds exist.
3. Where the business undertaken by the concern is quite large and the entries of the books to be checked are also quite large.
4. Where the management undertaken by the concern is quite large and the entries of the concern are monthly or quarterly.

Advantages

The advantages of a continuous auditing are as given below:

1. A thorough and detailed checking of accounts is possible. This is because, the auditor gets one complete financial year for the purpose, and he is not pressed for time.

2. The errors can be discovered and rectified soon. The opportunities for complicated frauds are lessened and they can be discovered before they attain larger proportions.
3. The auditor's visit throughout the year imposes a moral check over the members of staff and encourages honesty, efficiency and alertness. Hence, it develops their morale in the auditing process.
4. The continuous auditing motivates the accounting staff of the client to keep the books of account up to date.
5. It can be completed very fast and final accounts can be presented immediately. So that, it facilitates the early declaration of dividend in the case of a company.
6. The auditor is able to acquaint himself with day to day activities of the particular business and with all the knowledge thus, attained he is less likely to omit the important points and is able to discharge his duties more effectively.
7. It is convenient to the auditor. In fact, he can make easy arrangement for his work. He can spread his work over the whole financial period and may seek greater co-operation from his staff.
8. The properties may get any desired information duly verified without any difficult.

Weaknesses: However, a continuously auditing has some weaknesses which are as given below:

1. The remarkable disadvantage is that the items or figures may be altered and books of accounts may be tampered by client after the auditor has checked them. However, it may be noted that such alteration of figures after the checking is possible even in case of final or periodical audit as access to the books can be made in the absence of the auditor.
2. The auditor may lose the thread of his work. As audit is not carried on to a finish at a stretch, it may result in the omission of completing the work left over during his last visit.
3. It may be possible that the audit work may become too mechanical since it continuous throughout the year. But this is not any serious objection and can be minimised by judicious allocation of work among the staff members.
4. It has got another limitation in the sense that it is expensive. Therefore, the cost of continuous auditing may be so prohibitive that its advantages cannot be had by the smaller concerns.
5. The auditor's frequent and often unexpected visit may cause inconvenience to the client.

Interim audit: It refers to carrying out of auditing at any time during the year, or in the middle of financial year in order to ascertain the interim profit or loss or state of financial affairs of the concern. For instance, the director of a company may desire to declare interim dividend or bonus only when first half-year is over. It would necessitate the interim audit to be carried out to ascertain true profits of the concern for the period. Or in the case of a firm, audit of final accounts may become necessary in the middle of the year in the event of admission, retirement or death of a partner. Such auditing would save time in the final auditing. Further, it may enable the auditor to gather some importance points with regard to the concern. It may also help him later while conducting the final auditing.

Distinction between Continuous and Interim Audit

Generally, there is a confusion between the continuous and interim auditing. The following differences between the two may be pointed out to understand them clearly.

1. The objectives of continuous auditing is not to find out the profit or loss of the concern for a given period whereas in case of interim auditing it is undertaken with a specific objective of finding and checking the profit or loss for a given period.
2. Under the continuous auditing, the accounting records of one accounting or financial year are examined thoroughly whereas in case of interim auditing, accounting records up to a certain date only are checked.
3. In case of continuous auditing, the trial balance is not prepared at intervals. On the other hand, in case of interim auditing the trial balance must be prepared and checked at the time of such auditing.
4. In case of continuous auditing, the verification of assets and liabilities are undertaken at the close of the financial period, whereas in case of interim auditing, it is undertaken at the time of such auditing.
5. The auditor's report is submitted at the end of financial year in case of continuous audit, but this is not so in case of interim audit. In the latter case, it is submitted at the time of auditing.

Cash Auditing: The cash auditing is undertaken with a limited purpose of examining the cash receipts and payments. It does not involve thorough checking of all the records. Often, it may involve even the preparation of cash book. The auditor should be careful in auditing cash book because it may contain manipulations. He should verify all the relevant vouchers and documents in order to satisfy himself that all the cash receipts and payments have been duly recorded. While reporting, he should also mention that he undertook only cash auditing.

Besides the general auditing, there are other kinds of auditing related to the joint stock and insurance companies in India. They are special auditing and cost auditing. We mention them below in detail.

Special auditing: The Companies (Amendment) Act 1960 has empowered the central government to order special auditing of the companies in certain cases. Under section 233A, it can direct special auditing of company accounts when:

1. The affairs of any company are not being managed in accordance with sound business principles or prudent commercial policies.
2. Any company being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains or,
3. The financial position of any company is such as to endanger its solvency.

The Central government may pass an order for conducting special audit of the accounts of any company for such period or periods as may be specified in the order. It may, by the same or a different order, appoint either a chartered accountant or the company's auditor himself to conduct such special audit. The auditor so appointed is known as special auditor and his powers and duties are provided under section 227.

The special auditor should submit a report which will not be addressed to the members of the company, as is done in the case of register audit but it will be addressed and submitted to the Central government. On receipt of his report, the government may direct such action as it considers necessary in accordance with the provisions of the Companies (Amendment) Act, 1960 or any other law for the time being in force. If the government does not take any action on the report within four months from the date of its receipt, a copy of the report of relevant extracts from it with comments thereon will be sent to the company by the government. It may require the company either to circulate the report to the members to be read in the next general body meeting.

It is important to note that the expenses of any special auditing including the remuneration of the special auditor which shall be determined by the Central government and is final. All such expenses shall be paid by the company and in default of such payment shall be recoverable from the company an arrears of land revenue.

Cost Auditing: The cost auditing refers to a thorough examination of cost accounting records of a company. It has been defined as the verification of the correctness of cost accounts and of the adherence cost account. Moreover, the plan prepared in this connection has been duly executed in cost auditing.

The Central government may direct for the cost audit of a company engaged in production, processing, manufacturing or mining activities (section 233B). In these cases, proper books of account would include such particulars relating to utilisation of materials of labour as may be prescribed, if such company is required by the Central government to include such particulars in the books of account. The government may also direct that the audit of cost accounts of a company shall be conducted in such a manner as to obtain a true and fair view of the state of affairs of the company.

The cost auditor's duties and powers are the same as prescribed in the case of auditor in general under section 227 (1) of the Act. Moreover, he will not submit his report to the members of the company but will have to submit it to the Company Law Board in such form and within such time as prescribed. At the same time, the auditor should forward a copy of the report to the company.

Besides the above classification of auditing, let us discuss some more concepts of auditing, as developed recently. There are joint auditing, propriety auditing, performance auditing and the system auditing.

Joint auditing: An auditing is a joint auditing when two or more persons or firms' chartered accountants are jointly appointed to conduct the audit in a company. The practice of appointing, joint auditors has been adopted by large-sized companies, specially the government companies, which want the pooling of the resources of two or more auditors so that the audit work undertaken can be expeditiously and quickly completed. As a result, most of the large-sized companies do not appoint single auditor but joint auditors. So far as the professional work is concerned, these joint auditors stand on equal footing. It may be pointed out that the Companies Act, 1956 is silent in this regard. It has not yet recognized this development statutorily.

Joint auditing may face certain problems also. There may be some difficulty in division of work and coordination. Further, there may also be difference of opinion between auditors. However, these problems can be solved by mutual discussion, consultation and agreement. So far as the liability of the joint auditors are concerned, the joint auditor has an individual responsibility only. Section 227 of the Act does not contemplate any division of work of audit between two or more person. Therefore, there is no question of joint liability according to the Act. It would not be quite proper also to hold an auditor responsible for the work not done by him but by another auditor. If there are two auditors, and both of them are responsible, that would create many practical problems.

While the Companies Act, 1956 silent on this issue, the Institute of Chartered Accountants of India has issued a statement on the responsibility of joint auditors. It has been made clear that it would not be correct to hold an auditor responsible for the specifically allotted work of another. Each joint auditor will be responsible only for the work allotted to him. In case, the work can be easily and clearly divided on the basis of identifiable operating units or specified area of work, the responsibility to perform the work assigned to one of the joint auditors with reasonable care and skill will be his alone. It is because the extent of work to be carried out is a matter of professional judgement and it may differ from auditor to auditor as no two firms or individuals will exercise this judgement in an identical manner. Thus, according to it, we cannot hold auditor responsible for the work done by another auditor who is equally qualified and competent to undertake the audit work. This also makes it clear that where the work cannot be clearly divided, the responsibility will be equal between them.

Propriety Auditing: The concept of propriety auditing is a new area in the history of auditing. The propriety auditing was contemplated in case of government auditing long back. Prof W. A Robson had made a strong plea for the adoption of efficiency-cum-propriety auditing in 1937. He had advocated for the appointment of efficiency audit commission for the purpose of carrying on detailed checking specially for the nationalised industries of UK. In July 1967, again he made a strong case for such audit for the nationalised industries. However, it has been adopted only recently Thus, it is only very recently that the efforts are being made in this direction. In our country, we have yet to evolve such auditing in its fullness.

However, a suitable definition of propriety auditing has not been developed so far. So, the meaning of the term propriety is not very clear. This is also because it is interpreted in various ways. According to Eric L. Kohler, "Propriety auditing may be defined as that which means the tests of public interest commonly accepted customs and standards of conduct. According to it, propriety auditing implies the verification of accounting records in such a way as to find out whether the actions and decisions have been taken in the public interest and in accordance with the commonly accepted customs and standards of conduct. Therefore, a number of comparison of accounting records with the related evidences is not enough. The auditors would have to take pain to see whether the transaction was 'justified or not'. According to Kamal Gupta "Propriety auditing refers to an audit in which the various actions and decisions are examined to find out whether they are in public interest and whether they meet the standards of consult". Thus, the propriety auditing is the 'one undertaken for verifying that there has not been any leakage of revenue misappropriation of assets or wastage of funds, due to a transaction or a group of transactions having been entered into either inadvertently or deliberately in regard of any legal requirement for an economic or financial consideration. It is a special investigation carried out for ascertaining the contract except relating to routine transaction entered into with third parties. It is done in the best interest of the concern and that there is a system which ensures the safety to the assets of the concern.

The propriety auditing can be distinguished from the performance auditing. The performance auditing is another function of auditing and differ from the propriety audit although both are the twin aspects of the management audit. The performance auditing has a certain procedures as stated below:

1. Analysing the profits and losses of different economic activities in which the concern is engaged,
2. Determining the relationship between production and sales,
3. Determining whether the sales pattern has deviated from the one considered ideal,
4. For maximising profits, and
5. Determining the imbalance if any in the inventory.

The propriety auditing has been undertaken in the various government departments. It has been the prime concern of the comptroller and auditor general of India. In auditing of private companies, the auditor has been mainly concerned with reporting of his opinion as to the truth and fairness of the financial state of affairs and the earnings of the company. In general, the auditor does not worry for the propriety auditing. However, it is not so in case of the government auditing, where its importance has been duly recognised, though not enforced with sincerity. According to Asok Chanda, former comptroller and auditor general of India, "Auditing is not an inquisition and its mission is not one of fault finding. Its purpose is to bring to the notice of the administration *lacunae* in the rules and regulations and to suggest, where ever possible, ways and means for the execution, of plants and projects with greater expediency, efficiency and economy". It brings in its ambit, the idea of propriety auditing. It indicates that mere testing the accuracy of accounting and estimating is not enough but it is important that the expenses should be incurred wisely and economically and extravagance and wastages are duly avoided. He has also pointed out that his functions are not merely to ensure that the expenditure conforms to rules, but also to satisfy himself as to its wisdom, faithfulness and economy. The auditor has to be directed towards discovering waste and matters beyond accounting. The Government of India published a book, *An Introduction to Indian Government Accounts and Audit,* with certain principles have been mentioned which have long been recognised as standards of financial propriety. Therefore, the auditor should see those general principles have been duly adhered to.

Laxmi Narain points out that propriety auditing extends beyond the formality of expenditure to its wisdom, faithfulness and economy. The general principles applied there is that every public officer should exercise the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money. The auditor investigates the necessity for the expenditure incurred and asks whether individual items are in furtherance of the scheme for which the budget provided, whether the same results could have been obtained otherwise with greater economy and whether the rate and scale of expenditure were justified in the circumstances. In fact, the auditor claims to ask her every question that an intelligent taxpayer bent on getting the best value for his money could ask. Thus it involves enquiry against the propriety of expenses and not merely that expenses which been incurred and vouchers are presented.

Generally, in case of auditing of a private company, the duty an auditor does not extend to the area of propriety auditing. Section 227 of the Companies Act, 1956 also does not contemplate it. However, the duties of an auditor as provided under the above section can be extended by the shareholders though they cannot be curtailed. Thus, the shareholders of a company may desire to extend the duties of an auditor so as to include the propriety audit of the accounts.

Recently, certain amendments have been made in the Companies Act in such a way as to include propriety auditing of certain transactions entered into by a company. By the Companies Act, 1965 sub-section (1A) was added to section 227 of the Act. As a result, it has become obligatory for an auditor to enquire into the propriety aspect of certain types of transactions entered into by a company. In case, his enquiries show any irregularities, then, it is his duty to report the fact to them. The additional reporting requirements prescribed under section 227 (4A) of the Companies Act, 1956 also contain the matters when propriety aspects require due consideration on the part of an auditor.

Section 227 (1A) requires a company auditor to enquire whether or not the loans and advances made by the company on certain terms are not prejudicial to the interest of the company or its members. It also requires an auditor to enquire whether transactions of the company which are represented merely by book entries, and they are not prejudicial to be charged to revenue account. Thus, it has extended the duty of an auditor to tool into the propriety aspects while auditing the accounts of a company. Similarly, under section 227 (4A) the Central government has extended the duty of a company auditor to look into some propriety aspects of certain transactions. Accordingly, the government may direct that the auditor's report shall also include a statement on such matters as may be specified therein.

Provision of section 233 (B) of the Companies Act, 1956 related to the cost auditing also required the auditor to include in his report certain aspect related to the propriety of the transaction. Section 619 (3) of the Act which deals with the audit of government companies also provides for propriety auditing of such companies on several vital issues.

System Auditing: The enormous growth in the size of business enterprises has changed the traditional auditing. It gives way to a new technique of auditing known as system audit. This technique has been developed very recently in Canada and USA. It is gaining considerable popularity in the balance sheet auditing. Further, there has been very rapid growth of automation, use of computer and other sophisticated techniques to maintain records and substantial improvement in the design of internal control which have necessitated the use of modern technique of auditing. In fact, these development have received the auditor from various onerous work of verification of evidences and other records.

Thus, the system auditing is a detailed enquiry about the various systems of accountancy and controls prevailing in the enterprises and find out whether they are working efficiency or not with a view to formulate the opinion about the financial statements. In the words of Skinner and Anderson, "The system auditing is an attempt to explore inside the system and discover exactly how it produces results". If the mechanics of the system were analysed intensively and the detailed survey showed it to be designed with appropriate controls, checks and balances to forestall errors. Then, this would be a good indication that the results produced by the system are accurate. They further point out that the auditor attempts to 'make inferences about the whole of the accounting results from a knowledge of the detailed system which produced them.

A system auditing may also be termed as analytical auditing. However, it does not totally replace the independent balance sheet auditing. In fact, it is an aid to the latter. It helps the auditor in finding out whether the control systems are effective and reliable or not. This saves the time, botheration and cost of the independent auditing. The traditional auditing efforts are made to make a thorough checking of the accounting records with the related evidences. But the system auditing suggests that the control systems, as operative in the enterprise are quite effective and reliable. So, the auditor need not check the data in the above fashion. He can, then fairly rely upon the accounting data and devote his time and formulate his opinion to the truth and fairness of the financial statements.

The techniques adopted for the purpose of system auditing are also of recent origin and is highly technical. It requires full technical knowledge of the enterprise and various systems. Therefore, a mere knowledge of methods of keeping accounts would not be helpful. So, the auditor would have to be conversant with the various systems and their analysis. In fact, the technique of flow charting and the procedural tests are very helpful in finding out the effectiveness and reliability of the system.

The steps given below may be taken for the purpose of systems auditing:

1. Review the systems thoroughly
2. Test the systems with some representative samples and see the effectiveness
3. Prepare the flow charts thoroughly and analyses the same.
4. Find out the weakness and strength of the system
5. Plan the auditing on the basis of degree of reliability of the system
6. Make a thorough verification of transactions and find out where the weakness exists in the system.

The system auditing is of very limited use in a country like India where most of the enterprise do not have a well designed system. The mechanical accounting, specially use of computer, is not used in practice. A system auditing presupposes a well designed system and in their absence, there is no question of adopting this technique of auditing. It will become more popular with the adoption of automation and latest techniques of data recording and processing.

Auditing In-depth

A new concept similar to the system auditing is also gaining ground in the new dimension of auditing. In fact, the conventional auditing includes the work of vouching, verification and valuation. It is widely used but it is assisted by the auditing in-depth. At present, greater emphasis is laid upon the assessment of the prevailing system and the regulation of work in accordance with the application of such technique being covered by the expression 'auditing in-depth'.

According to Leslie R. Howard, "The auditing in-depth refers to the examination of the system applied within a business entailing the tracing of certain transactions from their origin to the conclusion. investigation at each stage, the records created with appropriate authorisation". It is expected that such an examination would enable the auditor satisfy himself as to the efficacy or otherwise of the system of internal control being operated.

It may be taken with regard to investigation of the purchasing system. A moderately large number of purchase requirements may be examined for proper authorisation. Then tested with purchase orders, a rather less number of those may be examined to adherence with the rules governing orders to suppliers. A number of these may be then tested with the goods inwards books and subsequently, with the invoices received and their system into sections and testing each of them on the pyramid basis. In other words testing greater number first and then lesser number at each stage.

They point out that the auditor must be fully acquainted with the prevailing systems to carry out the auditing successfully. At the same time, he should make himself conversant with the following main aspects:

1. The nature of business and its activities.
2. The accounting system in operation.
3. The duties and responsibilities of the staff.
4. The internal check system and the internal audit system.

The auditor should take efforts to gather necessary information in this respect. He should also examine nature of the business. If the control in the business is efficiently operated, he may get due information from the office manual, written staff instructions or flow charts. In case efficient control system is not in operation, he should gather necessary information from the management and staff and prepare the necessary records. Thus, an auditor may be required to undertake a detailed examination of certain transactions from the origin to the conclusion and satisfy with regard to its reliability. It is important to note that the more and more use of such technique, auditing in-depth would definitely bring about greater accuracy and reliability of the accounting records.

Internal Auditing

Internal auditing is a continuous and systematic examination and reporting the operation and records of a concern by its employee selected specially for this purpose. It is an auditing for the management and its scope may vary depending upon the nature and size of the concern. However, its development is directly attributable to the needs of the management resulting from the growth of large-scale business undertakings. It becomes impossible due to large size of the concerns and it depends upon outside or independent auditing service. Final auditing alone does not help much. At the same time, the continuous auditing is desirable for big concerns. Moreover, it is very expensive. Hence, increases the costs of independent auditing, time-lag between the transactions and its audit, the growing need for more than one annual checking and provision of a more potential tool of internal control, all necessitated the growing use of auditing activity by employees with the business unit. Now, it is increasingly realised that internal auditing is one of the functions of management. Many concerns employ internal check to perform much of these jobs, for this purpose some actual auditing is necessary to control internal check itself and ensure its effective application.

Definition

Washerbrook has defined internal auditing as "It is one that is carried out by the specialist staff of the organisation being audited and concern itself mainly with the routine checking of (usually) accounting transactions on a daily basis with the object of quickly locating irregularities, thus making it more difficult to perpetrate a fraud because of the constant nature of checking". This definition is very comprehensive one and it brings out the various changes in the features and objectives of internal auditing. The Institute of Internal Auditors (USA) has defined internal auditing as "An independent appraisal activity within an organisations for the review of accounting, financial and other operations as a basis for service to management. It is management control, which functions by measuring and evaluating the effectiveness of other controls". This definition also explains the term and has laid emphasis upon the independent appraisal of the related individuals in the organisation. It is not concerned mainly with the routine checking. This requires the internal auditors to go beyond the records in the books and review and report the performance in the area of finance, accounting and other related operations.

According to R.S. Waldron, there are twelve fundamental operations of internal auditing as given below:

1. It is a service to the management.
2. It provides assurance of an effective system of internal control that is excessive, of an effective system of internal control of accounts that is not excessive.
3. Ensures a reliable basis for production of accounts and statements of trading.
4. Polices the operation of established procedures and policies and sees that they are adequate not wasteful.
5. It highlights departures from established procedures.
6. Draws attention to deficiencies in the system control practice, etc.
7. Finds inefficiencies.
8. Suggests remedies and improvements.
9. Completes specially assigned work and report.
10. Needs status and independence.
11. Staff need training on objective judgements and experiences.
12. Looks beyond mere accounting functions.

The internal auditor has assumed several important functions besides assisting management. Being an employee of the concern, he is more familiar with it policies and procedures. In other words, he ensures the effective application of establishing policies, rules, procedures and internal check. Therefore, the auditor has to make constant review of internal control procedure and suggest necessary changes for the same. He should see whether the obsolete procedures are scrapped, loopholes are plugged and prompt corrective measures have been taken wherever necessary. He should guide and encourage for accurate and careful work by the other employees of the concern. In fact, he is of great assistance to the independent auditor in final auditing. He may be called upon by the management to make various constant efforts to find out weaknesses and defects in the procedures. He should suggest various measures in order to rectify the defects. Therefore, he should see whether the procedures and policies laid down by the management are carried out properly.

Differences between Internal Auditing and Independent or Statutory Auditing

There is not much difference in the method and procedures employed in internal auditing and independent or statutory auditing. However, one can come across the following differences in-between the two. Let us see them:

1. The main objective of internal audit is to fulfil the needs of the management whereas in independent audit the objective is to fulfil the needs of proprietors as well as third parties for reliable financial data.
2. The internal audit may be carried out by firm off practising accountants or by own staff but statutory audit can only be entrusted in India to a Chartered Accountant or a firm of Chartered Accountant engaged in public practices or to a Restricted State auditor.
3. The internal auditors approach is to ensure that accounting system is efficient so that the accounting information presented to the management throughout the period is accurate and disclose all the information that the management desires or requires. But the approach of statutory auditor is governed by his duty to satisfy that the accounts presented to the shareholders are true and fair view of the profit or loss of the concerns related to financial state of affairs.
4. The remuneration of internal auditor is paid by the management and the independent auditor by the shareholders.
5. The internal auditor is dependent on the management but the independent auditor is independent of the management.
6. The duties of an internal auditor may be reduced as desired by the management but it cannot be done in case of independent auditor.
7. Internal audit is carried on continuously throughout the year but independent audit is carried on periodically, usually once a year.
8. In internal audit, the examination work is quite detailed but in case of independent audit the testing techniques on the basis of random sampling are utilised to a large extent.
9. An independent auditor should submit a report to his shareholder after the audit work is over, but the internal auditor is not required to do so.
10. The service of an internal auditor can be easily terminated by the management but in case of an independent auditor only shareholders can remove him.

Degree of Reliance of Statutory Auditor upon Internal Audit

The internal auditing helps the statutory auditor. But it is not a substitute for the final auditing. The extent to which the statutory auditing should depend upon would differ from case to case. The degree of such reliance on internal audit, however, is a question of discretion which the statutory auditor, looking into his statutory responsibility must exercise carefully, as he cannot plead that he had relied upon the work done by the internal auditor. The statutory auditor cannot divert the responsibilities laid on him by the concern. The statutory auditor curtails the extent of his checking, putting reliance on the work of internal auditor. The responsibility for any deficiency in the financial statements that may remain undetected, will be that of statutory auditor.

The auditor should probe into the facts given below before he arrives at any conclusion regarding the degree of reliance to be placed upon internal auditing:

1. He should ascertain the efficiency of the internal audit. For this purpose, he should examine auditing programme, working papers and reports thoroughly. He should also check the work done by the internal auditor.
2. He should find out the experience and qualification of the internal auditor and his staff. He should also examine the reports of the management and the action taken by the management on the same.
3. He should find out the authority vested in the internal auditor and the level of management to which he is directly responsible.
4. He should also see whether the Internal Audit Department does only internal audit of the transactions or performs some other jobs. Moreover, he should ascertain the degree to which the Internal Audit Department is operating independently.

Thus, examining the usefulness of the work done by the internal auditor, the statutory auditor should apply his own discretion regarding the degree to which he may depend upon internal auditing. However, there is a need for co-operation between internal and external auditing.

R.S. Waldron has stated that the purpose of internal auditing is substantially different from those of external auditing. An internal auditor will do a certain amount of purely financial auditing, and also test the checking of the operation of a system in the same way as external auditors. He further states that 'there are substantial overlapping areas where both auditors are involved in checking the same book entries and testing the operation of the same system, where the external auditor can use the work performed by the internal auditor as a form of reliance, which can save his work. There is less benefit to be obtained by internal auditors from the external audit functions'. However, the wide experience of the independent auditor may be of assistance to the internal auditor. On the other hand, the latter's intimate acquaintance with business concerned might be of help to the independent auditor.

According to Lesilie R. Howard, the co-operation between the internal and external auditor may be understood in the following ways:

1. The independent auditor may rely on the internal auditor regarding the continuous operation of the internal check system and in the reliability of the accounting records.
2. Agreements of various aspects of the work are carried out only by the internal auditor together with the independent auditor, such as cash counts and visit to branches.
3. When the internal auditor co-operates with independent auditor, he may accept work done in respect of such matters as the confirmation of customers' accounts, the verification of assets and the audit working schedule prepared by the internal auditor.

According to the statement of auditing, the internal auditor's responsibility is to the management and he is in a sense a servant of the independent auditor. It follows, therefore, that the extent to which the internal auditor can so arrange his work as to be of specific assistance to the independent auditor. However, it will depend upon decisions of the management, scope of the internal audit and the number of staff employed thereon. Consultation between the two auditors is necessary with the management to ensure the practicablity of auditing and the fullest possible assistance is available to the independent auditor.

According to a survey held in Germany under the guidance of Andrew D. Chambers concludes that ‘There is an increasingly close relationship between internal and external auditing’. He sums up that ‘coordination exists in the majority of cases where this implies that the external auditor adapts his work in the case of what the internal auditor is doing. Coordination is less common, though increasing to a great extent. It implies that the external auditors participates in the determination of what the internal auditor shall audit.

It is interesting to note that with greater reliance on internal auditing. There is a possibility of reducing the fees to be paid to the external auditor which is high. M.G. Crabtree has rightly pointed out that extended reliance by external audit on the internal auditors certainly reduces the external audit fee. It is seen that the internal auditor plays an increasing part in the annual auditing process. There is increasing trend of reduction in time and scope of external auditing activities due to a greater use of internally generated reports and working papers prepared already by external auditor. The external auditors find it more useful to release more and more of their work to the internal auditors. According to Chambers, it happens at a time when the internal auditing emphasises has also been adopted to embrace operational audit areas outside accounting and finance which are not of primary significance in the statutory auditing.

New Provision

The importance of the internal auditing has increased tremendously with the passing of Manufacturing and Other Companies Order, 1975. It came into effect from January 1, 1976 and requires that the auditor’s report shall include a statement in relation to companies. The paid-up capital of which at the financial year concerned exceeds ` 25 lakhs whether the company has an internal auditing system, commensurate with the size and nature of its business. Thus, the internal auditing has been made compulsory for such companies.

The order has covered about 5,686 companies of the country. It is important to note that India has the third largest membership of internal auditors with about 908 members already enrolled. The USA and UK rank first and second with membership of 15,000 and 8,000 respectively. This order has provided a statutory status to the internal auditing in the country.

Internal Audit and Management

A wide gap is created between administration and front line operation due to the increase in the size of the business unit. As remoteness increases, so the factors such as misunderstanding, misinterpretations, delay and ill-conceived judgements operate to put obstacles in the way of efficient management. The internal auditing is used by the management to bridge the gap by serving as an independent check on the accounting and other operations of the organisation. The internal auditing can assist the management to control the operation of the organisation in the following ways:

1. Ensuring compliance with the manual of operation;
2. Recommending improved system especially to cover areas where control is lacking or objectives are not being achieved.
3. Simplifying overcomplicated or overcostly controls or recommending their abandonment where their value is not equal to their cost.
4. Protecting the company’s assets and recommending improvements in such safeguards.
5. Ensuring economic use of resources within a business.
6. Improving the form content and reliability of information.
7. Eliminating and controlling waste.

Thus, the internal auditing is used by the enlightened management as an important tool to bring about the desired control with a view to improve efficiency and achieve the predetermined goals.

Recent Trends

Internal auditing is the process of evolution at a faster rate. Several trends are visible in this area. Some important trends are as follows:

1. There is an increasing emphasis that the internal audit should serve organisation as a whole and not merely the management of the organisation. The internal auditing is an arm of the management. It is changing fast in the auditing world.
2. It evolves to embrace the auditing of all operations and not merely accounting and financial matters. It is not simply concerned with audit of compliance with internal and external procedures and regulations. But it is more concerned with the appraisal of efficiency and effectiveness.
3. The internal auditing gives due emphasis on the risk management and more auditing effort is extended to prevent the problem of auditing.
4. Internal auditors are concerned with reviewing of the corporate attitudes. For instance, innovation, work, risk, resources, stewardship and staff development. It is important that success or failure of the organisation depends upon them also.
5. The internal auditors are required to undertake participative auditing and have to adopt the teamwork approach. This has become necessary because of growing emphasis upon the efficiency and effectiveness of auditing.
6. It may be true that being an employee of the organisation, internal auditor is supposed to lack independence in his working. However, there is a growing realisation that within the given framework. He should be given the independence to work. It does not imply independence from management but it means independence from the management of a particular auditing area.

Objectives of Auditing

The principle objectives of auditing have been changing with the advancement in the principles and conduct of business. In fact, earlier it was in the form of merely cash auditing and its main objective was to ensure the correctness of accounting for all the receipts and payments. Later on, detection of errors and frauds became the main objectives of auditing. An auditor used to arrange several surprise visits to a client in order to ensure auditing. The aim was to catch those employees who were in arrears in their work, or had committed some frauds, or were guilty of errors, for which they could not have time to cover. Now, his visits to the clients are not in the nature of a surprise. He makes arrangement with his clients for the purpose of auditing of the accounts. His tools have much improved to conduct the auditing in a planned way. The time at his disposal is short and time work is wide. He should deal with the accounts of huge concerns even through the arranged visit to his clients. He can detect errors or frauds as he used to do in a surprise visit.

The main objective of auditing is to detect errors and frauds in the books of accounts. However, detection of errors and frauds is simply an incident. In fact, by auditing the accounts of a concern, the auditor does not assure that they are free from errors or frauds. Unless he has been specially appointed to investigate errors and frauds, he is not expected to unearth them fully. Thus, there is a general belief that audited accounts would be free from such errors and frauds. Anyhow, this is not wholly correct.

The another objective of auditing is to find out whether the accounts of a particular concern exhibit a true and fair view of the earnings and financial state of affairs. In the words of Kohler, "The purpose of the opinion is to assure others that current objective standards of information and presentation have been observed, standards to which both profession and public bodies have contributed for many years, standard designed to provide readers of financial statements with useful information."

According to Taylor and Perry, "Today the main objective is to ensure that the accounts reveal a true and fair view of the business, and its transactions". This leads to a great emphasis on ascertaining the reliability of records from which the accounts are drawn up and also on verifying the assets, liabilities and transactions within the accounts. Thus, reliability of the accounting records has become more important principal objective of an auditing in the commercial world.

The main objective of auditing has also been made clear in section 227 of the Companies Act, 1956. It requires the auditors of a company to state in his report whether in his opinion their accounts give a 'true and fair view' in case of a balance sheet of the financial state of affairs of the company at the end of a given financial year and in case of profit and loss account, of the profit or loss for its financial year. Thus, the main objective is to form an independent judgement and opinion about the regularity and reliability of accounting records and truth and fairness of financial state of affairs and working results.

When an error appears in the accounts, it assumes the character of a fraud. When an error is committed intentionally or deliberately with a view to deceive or defraud somebody, then that error is known as fraud. Fraud is a false representation or entry which is always made intentionally with some mischievous objective.

A Fraud Contains Certain Elements which are given below

1. There must be an untrue positive representation.
2. The representation must have been made with the full knowledge of its falsehood.
3. The representation must relate to a fact and not of law.
4. The main aim is to deceive or defraud some body.

Types of Fraud

A fraud may be three types:

1. Misappropriation of cash,
2. Misappropriation of goods,
3. Manipulation of accounts.

1. Misappropriation of Cash

Misappropriation of cash refers to wrongful conversion or fraudulent application of cash. It is also known as embezzlement of cash. Embezzlement refers to the fraudulent appropriation of another's property by somebody to whom it was entrusted. When the contact between the proprieter and the cashier is not so close, any person can misappropriate money. A transaction relating to cash receipt may either go totally unrecorded or recorded at a figure less than the actual figure.

Misappropriation of Cash can be Located in the following Manner:

1. The auditor should verify the cash book entries with those in the rough cash book
2. He should verify the vouchers, wage sheet, salary bill, invoices and other accounts in order to locate the fraud on the payment side of the cash book,

Payment: Misappropriated money shown as wages in the wage sheets by entering dummy names of workers.

2. Misappropriation of Goods

Misappropriation of goods is easy in those cases which deal with goods which are less bulky and are of higher value. Fraud in respect of goods cannot easily be detected. However, the auditor can bring fraud to light only by detailed cheeking. He should check up the stock records, purchases and sales very carefully. Generally, goods which are small in size and are of higher values are not recorded properly in the accounts. Misappropriation of goods can be located in the following manner:

1. The auditor should ensure whether the concern maintain proper books of accounts for purchases and sales.
2. He should also ensure whether the concern has proper internal checks in the matters related to purchases and sales.
3. He should check up the stock records, purchase and sales carefully.
4. He should compare the rate of gross profit of current year with that of the previous year.

3. Manipulation of Accounts

The accounts of a business can be falsified by making false entries respect of fictitious sales or purchases. Whenever such a class of fraud occurs, it usually involves very large amount. It can be detected by the auditor with great difficulty. This is done through falsification of accounts and financial statements. Therefore, it is known as falsification of accounts. Normally, this is done by higher officials and dishonest employees of a business.

Showing More Profits than the Actual so as to:

1. Earn more commission on profit
2. Win the confidence of shareholders
3. Fetch high price for their shares
4. Enjoy better reputation to get credit
5. Attract more persons to subscribe more for the shares

Showing Less Profits than the Actual so as to:

1. Mislead income tax authorities
2. Reduce or avoid liability for income tax.
3. Purchase the shares in the market at a lower price.
4. Purchase materials in the market at a lower price.
5. Avoid wage increment and other economic benefits to the employees.

The Following are Some of the Devices to Falsify Accounts:

1. Providing less or more or non providing for depreciation on various assets.
2. Overvaluation or undervaluation of assets and liabilities

3. Inflating or deflating profits by entering non existent items
4. Charging capital expenditure to revenue accounts or *vice versa*
5. Inflating profits by omitting to record some items of expenditure
6. Utilising secret reserves without making the fact known to the shareholders.
7. Showing income of the next year to the current year's profit and loss account and
8. Window dressings, that is, showing outwardly a more prosperous position than what it actually is.

Duties of an Auditor Regarding Detection and Prevention of Errors and Frauds

It is the duty of an auditor to detect and prevent errors and frauds. The auditor should exercise considerable care and skill in order to detect errors and frauds. To the best of his knowledge, care and skill, he should certify the accounts as correct. He cannot be held responsible for an error or fraud which is still there in the accounts.

The auditors cannot do anything concretely to prevent errors and frauds. But he can advice the client to prevent such issues if he is demanded so. If his advice is taken properly, chances of errors and frauds can be reduced to a certain extent. In the case of Kingstons Cotton Mills Ltd., it was held that an auditor is a watch dog and not a blood hound. There are two important points in the judgement:

(a) An auditor is a watch dog which means that he is appointed to look after the interests of the owners of a business.

(b) It is not the duty of the auditor to take action against those who have been found guilty of committing errors and frauds in the accounts.

Qualities of an Auditor

An auditor should be a chartered accountant. There are some qualities which are inherent in him. There are some other qualities which he should acquire so as to make auditing meaningful, purposeful and successful one. Therefore, an auditor must possess the necessary techniques of doing his work. In short, he should be an expert in his work and should be a man of character and noble behaviour. Generally, an auditor must possess some important qualifications and qualities as mentioned below:

Caution: The auditor should be very cautious and vigilant. He should be bold enough to discharge his duties faithfully, stand honestly when he faces an awkward situation.

Tracing out facts and figures: The auditor should have abilities to trace out the facts and figures. He should possess an ability to pass accounts only when they reveal the true and fair state of affairs.

Not to disclose secrets: The auditor should not disclose the secrets of his client.

Extract the necessary information: The auditor should be so clever that he may be able to extract the necessary information in full. For this, he should be capable of preparing a proper questionnaire having intelligent questions.

Courage and Ability: The auditor should have the necessary courage and ability to write out his report clearly, correctly, concisely, and forcefully. He must possess common sense. He should be hard-working and accurate. He should be well behaved. Above all, he should be cabable in all respects:

1. **Idealism:** The success of any profession is built upon the idealism in which the profession was founded. This quality is applicable to the auditor also.

2. **Culture:** An auditor must be cultured. Culture can be acquired through study and reading and maintaining cordial relationship with the social environment.
3. **Leadership:** The quality of leadership is essential for an auditor. The professional status cannot be attained without such one.
4. **Character:** The auditor must possess a pleasing personality. For example, tact, judgement, resourcefulness, imagination, initiative, curiosity, self-control, dignity and the ability to take up responsibility.
5. **Knowledge of Accounting Theory and Practice:** The auditor must have a wide knowledge of the theory and practice of Accountancy. He should be familiar with the underlying principles and should be capable of applying them without difficulty to transactions.
6. **Knowledge of Taxation Laws:** An auditor should be thorough with the Central, State and local taxation laws and procedures.
7. **Knowledge of Cost Accounting and Budget Preparation:** Correct costing is required to ascertain the true income figures. Also, he must be thorough with the preparation of budget and its control.
8. **Ability to Install Accounting System:** An auditor must be able to install accounting and office operation systems.
9. **Mastery of Modern Auditing Procedures and Practices:** An auditor is expected to have complete knowledge of the principles and practices of auditing.
10. **Knowledge of Commercial Law:** He should have a thorough knowledge of the laws of sales, contracts, agency, negotiable, instruments, insolvency and bankruptcy.
11. **Honesty and Tactfulness:** An auditor should be tactful and honest. According to Lord Justice, 'An auditor should be honest. He must state clearly what he believes to be true, and he must take reasonable care and skill before he believes what he certifies is true. He must have the courage to carry out his duty faithfully and he should be prepared to resign rather than sign a balance sheet which he knows does not exhibit a true and fair view of the state of affairs of the concern and thus give a false report.
12. **Knowledge of the Business:** He should be able to grasp easily the technical details of the business whose accounts he is going to audit. It will be helpful to him to carry on the work of audit if he visits the works of his client before he begins an audit.
13. **Ability to Maintain Secrecy:** Every business will have certain secrets. Therefore, an auditor is not expected to disclose the secretes of his clients.
14. **Knowledge of Finance and Economics:** A thorough knowledge of finance and economics is essential for maximising efficiency. Therefore, the auditor must be well versed in the different phases of finance like corporation, partnership and personal. A good knowledge of the principles of economics which govern the modern industrial life, is also required.
15. **Experience and Training:** No one can be expected to be a leader in his field unless he has a great amount of experience and rigorous training under proper guidance. So an auditor must acquire proper experience and training.
16. **Common Sense:** This is an important quality that an auditor should possess.
17. **Mastery of the Language:** Auditor must be able to speak and write well both English and the local language. He must be able to write the reports forcefully and in a good style. It should not be stereotyped.

Advantages of Auditing

The audit of the accounts of a concern has many advantages and in the case of a joint stock company, it has been made compulsory by law. The organisation of the business concerns has become so complex that an individual or group of individual cannot look into every aspect of the concern. The old controversy says that 'Accountancy is a necessity, while auditing is a luxury' is over now in the present set-up of the business world:

1. It ensures the correctness of the accounts to a great extent. The truth and fairness of the financial statements are certified properly. It helps a lot to the proprietors, managements or anybody who deals with a particular concern. The reliability of the accounts and financial statements is ensured through auditing.
2. It enables the detection and prevention of frauds and errors in the books of accounts. As such, it serves not only as a corrective measure but exercises a great moral influence on the whole staff putting a check upon the dishonest employees.
3. A regular audit makes the staff so alert and vigilant that the books of account and all other records are kept up to date. This is essential to prevent the application of wrong principles and methods in accountancy, as well as carelessness and irregularity on the part of the staff.
4. The audited accounts enables the comparison of accounts from year to year. It helps to find out the fluctuations in the accounts.
5. The audited accounts are helpful in obtaining additional capital or borrowing money from the banks or other sources.
6. In case of loss by fire, the compensation may be claimed from the insurance company on the basis of the previous audited accounts. The estimates for the claim must be scientific and based on reliable past records.
7. It helps in the valuation of the property or goodwill of a concern, when the business has to be sold or a firm has to be converted into a joint stock company.
8. The audited accounts are taken to be more reliable by the tax authorities for purposes of tax assessment.
9. Audited accounts are more reliable as evidence in the court of law.

Limitation of Auditing

Though there are numerous disadvantages of auditing, it suffers from the limitations given below:

1. **Not Revealing Complete Picture:** The auditor should depend upon the facts while examining the books of accounts. Moreover, auditing does not reveal the complete picture of accounts when the information has been wrongly manipulated in the report.
2. **Incomplete or Incorrect Information:** The auditor should depend upon the explanations, clarifications and information from the client or some responsible person. The auditor may have to submit his report under such handicaps when he does not get complete information or necessary clarifications.
3. **Incorrect or Wrong Certificates:** An auditor is not expected to be an expert in all areas. However, he should get the certificates from the experts. Hence, the auditor may have to give a wrong report when the experts issue wrong certificates.

4. **Not Serving of Real Purpose:** The auditing of book of accounts may not reveal the purpose until an auditor is independent and bold enough. When an auditor does not possess submission of clean report, the report does not serve the real purpose.
5. **No Guarantee as to Correctness of Accounts:** As detailed checking is not possible, the auditing does not give any guarantee as to correctness of financial accounts of a concern.
6. **Post Mortem Examination:** Auditing is like a post mortem examination. It is useful for the future but less helpful for the past.
7. **Application of Faulty Techniques:** Where an audit technique is not consistent with the nature or type of the business enterprise, it will not provide the right kind of evidence and even auditing the may not tell the entire story.

Conclusion

Auditing is the latest development in the business world. In fact, it plays a vital role not only in maintaining the records of various accounts but also finding out the errors and frauds in the financial statements. It is seen that a lot of transactons are carried out for land, buildings, infrastructure, machines, equipment, raw materials, transport, communication, wage and salaries, purchase and sales, and other business. Financing is the sole and centre of any business activity. There is a lot of possibilities for error or fraud when the transaction are entered in the records. Auditing is the effective tool to rectify such wrong entries and helps to maintain the reliability of the concern from the socio-economic and ethical point of view. Therefore, education, religion, medical, politics, industries either small or large and any business need auditing in a materialistic society.

Questions

1. What is auditing?
2. Define auditing.
3. What are the objectives of auditing.
4. Distinguish between auditing and investigation.
5. State the difference between internal auditing and independent auditing.
6. Discuss the different types of auditing.
7. Explain the difference between auditing, bookkeeping and accountancy.
8. What do you understand by statutory auditing?
9. What is meant by continuous auditing?
10. What do you meant by “routine checking” and “vouching”?
11. “Accountancy is a necessity while auditing is a luxury – comment.
12. Discuss the qualities of an auditor.
13. What is meant by periodical auditing?
14. Describe the need and importance of auditing.
15. Auditing begins where accountancy ends – Comment.
16. Briefly explain the classes of errors and frauds.
17. Discuss the merits and demerits of auditing.

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