

# AUDITING

( For Undergraduate Classes )

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## PREFACE

This Text-Book of **Auditing** is specially prepared for undergraduate Students . It is prepared in accordance with the latest syllabus given in this book.

I do not claim any originality in the subject-matter of this book. I have drawn immense material from many standard books on this subject. Yet, this book is original in the exposition and presentation of the subject-matter. The subject-matter has been dealt with exhaustively and in very simple language.

I express my profound gratitude to the **United Publishers, Mangalore,** for bringing out this book.

I shall consider my efforts amply rewarded if this book is found useful by the teachers and the students.

Suggestions for improvement of this book will be gratefully accepted.  
**Mangalore.**

**B.S. Raman**

# AUDITING

## SYLLABUS

### Unit I:

Introduction-Definition of Auditing, Scope of Audit. Objects of an Audit. Classification of Audit-Statutory, Private, Government, Internal, Continuous, Annual, Interim, Partial, Balance Sheet, Cost, Tax and Management Audit- Meaning. Preparation before Audit-Distribution of work, Audit programme, Audit Files, Audit note book, Audit working papers. Procedure of Audit, Techniques of Audit. 12 hrs.

### Unit II:

Internal Control- Meaning, Definitions, Principles

Internal Check - Meaning, Definitions, Objects, Merits and Demerits, Internal check relating to Cash, Wages, Purchase, Sales and Stores.

12 hrs.

### Unit III:

Vouching- Meaning, Objects and Significance.

Vouching of few important Items- Cash Receipt Transactions-Cash Sales, B/R, Receipt from debtors, Proceeds from sale of fixed assets, Cash purchases, Payment of creditors, Wages, Salary, Remuneration to an auditor, B/R, Purchase of land and building, Plant and Machinery, Investment, patents and copy rights, Advertising, Petty cash book. 12 hrs.

### Unit IV:

Verification of Assets and Liabilities- Classification of Assets and Verification and valuation of different assets- Fixed, Floating, Wasting, Intangible.

Valuation of Stock

Verification of Liabilities - Meaning and Auditor's duty. 12 hrs.

### Unit V:

Appointment, Remuneration, Rights and Duties of auditors of joint stock companies. The Liability of the Company auditor- Civil liability - Liability for Negligence -legal decision-Leeds Estate Building and Investment Society, Vs. Shepherd (1887), London Oil Storage Co. Vs Sear Hasluck and Co. (1904) Liability for Mifefasance-Legal decision-London and General Bank Case, Kingston Cottom Mill Ltd. Union Bank, Allahabad, Criminal Liability- Legal decision under the Indian Penal Code. Auditor's Report-Meaning, Importance, Meaning of clear and qualified report, Professional ethics- meaning, professional misconduct. 12 hrs.

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# UNIT I : INTRODUCTION TO AUDITING

## DEFINITION AND MEANING OF AUDITING OR AUDIT

### Auditing in the Literal Sense:

The term 'audit' is derived from the Latin word 'audire', which means 'to hear'.

In ancient times, whenever frauds were suspected, the proprietors of business firms used to appoint some experienced and impartial persons, ordinarily judges, to check the correctness of the accounts of their firms prepared by their book-keepers (i.e., the persons who had maintained the books of accounts). The persons appointed to check the correctness of the accounts used to only hear from the book-keepers all the accounts relating to the business, and, on the basis of the hearing of accounts, would express their opinion about the correctness or otherwise of the entries made in the books of accounts.

The hearing from the book-keepers all the accounts relating to the business came to be known as audit or auditing, and the persons who heard from the book-keepers all the accounts relating to the business came to be known as auditors. So, literally, 'audit' or 'auditing' means hearing, and 'auditors' mean 'hearers'.

### Auditing in the General Sense:

Now, let us consider the meaning of the term 'audit' or 'auditing' in the ordinary or general sense. Initially, the term 'audit' or 'auditing' was taken to mean examination of the books of accounts of a business to ascertain whether the persons in charge of receiving and paying cash and maintaining the books of accounts had properly accounted for all the cash receipts and cash payments on behalf of their principal (i.e., the owners of the business). In other words, initially, the term 'audit' or 'auditing' was taken to mean checking of the books of accounts of a business to find out whether cash had been embezzled (i.e., misappropriated), and if so, who had embezzled it (i.e., the cash) and how much of cash had been embezzled. In short, in the beginning, the term 'audit' or 'auditing' meant only 'cash audit' (i.e., examination or checking of the cash receipts and cash payments).

### Modern Concept of Auditing:

However, over the years, the meaning of the term 'audit' or 'auditing' has undergone a considerable change. Today, audit or auditing (i.e., audit or auditing in its modern concept) means a thorough and critical

examination of all the books of accounts and records of a business by an independent person or body of persons, qualified for the job, to verify the arithmetical accuracy of the accounts as well as the authenticity and the truth of the transactions recorded in the books of accounts and in the financial statements, and to report to the owners of the business whether the profit and loss account gives a true and fair view of the profit or loss of the business for the financial period, and the balance sheet gives a true and fair view of the state of affairs of the business at the end of the financial period.

The above meaning of audit or auditing in its modern concept (i.e., modern audit or auditing) is borne out by the definitions given by several writers on the subject 'auditing'. So, let us consider some of the important definitions of 'audit' or 'auditing', and understand how far the above meaning of modern audit or auditing is borne out by those definitions.

Spicer and Pegler have defined audit as "such an 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 affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as is shown by the books, and if not, in what respects he is not satisfied." According to this definition, auditing is the systematic and scientific examination of the books of accounts and the records of the business to verify whether the balance sheet and the profit and loss account are properly drawn up, and to report whether the balance sheet gives a true and fair view of the financial position of the business, and the profit or loss account gives a true and fair view of the profit or loss of the business.

In the words of F.R.M.De Paula, "An audit denotes the examination of a balance sheet and profit and loss account prepared by others together with the books, accounts and vouchers relating thereto in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion, such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern, according to the information and explanations given to him and as shown by the books." This definition just endorses the view of Spicer and Pegler. To be specific, according to this definition also, auditing is the systematic and scientific examination of the books of accounts and the records of a business for the purpose of ascertaining and reporting



whether the financial statements are properly drawn up and whether they give a true and correct view of the profits and the financial position of the business.

According to 'L.R. Dicksee, "Auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. In some instances, it may be necessary to ascertain whether the transactions are supported by authority." According to this definition, auditing is the examination of the accounting records to establish whether the transactions of the business have been undertaken with proper authority, and whether the accounting records correctly and completely reflect the transactions to which they relate, and also to report whether the financial statements (i.e., the balance sheet and the profit and loss account) prepared from the accounting records portray a true and fair picture of the business.

Montgomery defined auditing as 'a systematic examination of the books and records of a business or other organisation in order to ascertain or verify and to report upon the facts regarding the financial operations and the results thereof." According to this definition, auditing is the systematic examination of the books of accounts and the records of a business organisation or any other organisation to verify and report upon the facts regarding the financial operations and the financial results (i.e., the profit or loss and the financial position).

J.R. Batliboi defined audit as "an intelligent and critical scrutiny of the books of accounts of a business with the documents and vouchers for which they are relied upon for the purpose of ascertaining whether the working results for a particular period as shown by the profit and loss account and also the exact financial condition of the business as reflected in the balance sheet are truly determined and presented by those responsible for their compilation." According to this definition, auditing is a critical examination of the books of accounts of a business with the vouchers and other documents for the purpose of ascertaining whether the working results (i.e., the profit or loss) of the business for a particular period, as shown by the profit and loss account, and the exact financial position of the business at the end of the period, as shown by the balance sheet, have been truly determined and presented by those responsible for their preparation and presentation (i.e., by the book-keepers).

All the above definitions clearly indicate that auditing in its modern concept (i.e., modern auditing) (i) is a systematic, intelligent, scientific,

critical and thorough examination of books of accounts of a business, (ii) maintained by others, (iii) by an independent person or body of persons qualified for the job, (iv) with the help of vouchers, documents, information and explanations received from the authorities, (v) for the purpose of ascertaining (a) whether the transactions entered in the books of accounts are genuine, (b) whether they (i.e., the transactions) have been entered into with proper authority, (c) whether they are arithmetically accurate, (d) whether the accounts and the financial statements have been prepared in accordance with the law and (e) whether the profit and loss account gives a true and fair view of the profit or loss of the business for the financial period and the balance sheet gives a true and fair view of the financial position of the business at the end of the financial period, and (vi) reporting his findings to the owners of the business who have appointed him. In other words, auditing is a critical examination of the records and the books of accounts of a business by an independent qualified person for ascertaining the authenticity (i.e., the genuineness) and the accuracy of the entries appearing in the books of accounts and the financial statements, and reporting to the owners of the business whether the financial statements give a true and fair view of the profit or loss of the business for the financial period and the financial position of the business at the end of the financial period.

### IMPORTANT ELEMENTS OR FEATURES OF AUDITING OR AUDIT

The various definitions of auditing, discussed so far, throw light on the important elements, aspects or features of auditing. **The important elements or features of auditing are:**

#### 1. Systematic and scientific examination of books and financial statements:

**Auditing is a systematic and scientific examination of the books of accounts and financial statements of a business.** In other words, it is a thorough, intelligent, analytical and critical examination of the books of accounts and the financial statements prepared from the books of accounts.

#### 2. Inspection, checking, verification and scrutiny:

**Auditing, i.e., the systematic and scientific examination, involves inspecting, comparing, checking, reviewing, ascertaining, scrutinising, examining and verifying the vouchers supporting the transactions.** In short, auditing involves inspecting, checking, verification and scrutiny of the vouchers.