AUDITING

5th semester

TOPIC :

BASIC CONCEPTS OF AUDITING

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AUDITING INTRODUCTION, MEANING AND DEFINITION

INTRODUCTION:

The audit is an intelligent and critical examination of the books of accounts of the business. Auditing is done by the independent person or body of persons qualified for the job with the help of statements, papers, information and comments received from the authorities so that the examiner can confirm the authenticity of financial accounts prepared for a fixed term and report that:

- The balance sheet exhibits an accurate and fair view of the state of affairs of concern;

- The profit and loss accounts reveal the right and balanced view of the profit and loss for the financial period;
- The accounts have been prepared in conformity with the law.

Meaning of Auditing:

The term audit is derived from a Latin word "audire" which means to hear authenticity of accounts is assured with the help of the independent review.

Audit is performed to ascertain the validity and reliability of information. Examination of books and accounts with supporting vouchers and documents to detect and prevent error, fraud is the primary function of auditing. Auditor has to check the effectiveness of internal control systems for determining the extent of checking out the audit.

Initially its meaning and use were confined merely to cash audit, and the auditor has to ascertain whether the persons are responsible for the maintenance of accounts had adequately accounted for all the cash receipts and the payment on behalf of this principle.

Definition of Auditing:

"An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which the purport to relate." –Lawrence R. Dickey

"Audit such an examination of the books of 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 fair and true view of the state of affairs of the business and the whether the profit and loss of accounts gives a true and fair view of profit and loss for the financial period according to the best of his information and explanations given to him and as shown by the books and if not in what respect he is not satisfied." –Spicer & Pegler

Auditing Origin and Evolution

The auditing origin can be traced back to the 18th century, when the practice of large scale production developed as a result of the Industrial Revolution.

Systems of checks and counter checks were implemented to maintain public accounts as early as the days of ancient Egyptians, Greeks and Romans.

The last decade of the 15th century was a crucial period during which a great impetus was given to trade and commerce by Renaissance in Italy, and the principles of double entry bookkeeping were evolved and published in 1494 at Venice in Italy by Luca Paciolo.

This system of accounts was quite capable of recording all types of mercantile transactions.

The Industrial Revolution of England was another landmark in the history of trade and commerce.

- The industrial revolution led to a significant expansion in the volume of trading transactions which compelled the use of more money, and the ordinary trader was enforced to combine with the partnership with others.

- Consequently, a big enterprise was framed in the form of partnership firms and joint-stock companies.
- This growth of business enterprises before and after the revolution accompanied an improved accounting system.
- Besides British Companies made stockholders realize that an independent and impartial audit could well protect their interest.

- Such developments had a direct effect on the evolution of the practice of auditing, but the audit of business accounts could not be standard until the 19th century.
- A Royal Charter incorporated the Institute of Chartered Accountants in England and Wales on May 11, 1880. The key purpose of this incorporation was to prepare Auditors.

In January 1923, the British Association of Accountants and Auditors got established, and a person could be fully competent to work as a professional auditor after clearing this exam.

Objectives of Auditing

There are two main objectives of Auditing.

Primary Objective

The main objective of an auditor is to report to owners that the financial accounts give an accurate view of the situation of the company's activities.

Secondary Objective

The secondary objective is also known as incidental objective as it is related to the fulfillment of the primary purpose.

The incidental objectives of auditing are as follows:

- Detection and prevention of scams
- Discovery and prevention of mistakes

- Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the primary aim of determining whether or not the financial statements give an accurate and fair view. Frauds can take place due to the manipulation of accounts, and it is essential for the auditor to find the fraud so it can be prevented in the future.
- Errors refer to an accidental mistake in the commercial data arising due to ignorance of accounting procedures.

Importance of Auditing

The **importance of auditing** cannot be overstated. A good auditor is not only able to clear your issues quickly, but also helps you improve your company. Although the main reasons for a financial audit have to do with business and legalities, you shouldn't forget the psychological aspect that is very important when dealing with other entities, such as banks, clients and shareholders. If you conduct regular audits, you will generate more **confidence** from the people you work with, as well as with government institutions.

THE THREE DIFFERENT TYPES OF AUDITS

ISO 19011:2018: defines an audit as a "systematic, independent and documented process for obtaining audit evidence [records, statements of fact or other information which are relevant and verifiable] and evaluating it objectively to determine the extent to which the audit criteria [a set of policies, procedures or requirements] are fulfilled." There are three main types of audits:

Process audit: This type of audit verifies that processes are working within established limits.

It evaluates an operation or method against predetermined instructions or standards to measure conformance to these standards and the effectiveness of the instructions. A process audit may:

Check conformance to defined requirements such as time, accuracy, temperature, pressure, composition, responsiveness, amperage, and component mixture.

Examine the resources (equipment, materials, people) applied to transform the inputs into outputs, the environment, the methods (procedures, instructions) followed, and the measures collected to determine process performance.

Check the adequacy and effectiveness of the process controls established by procedures, work instructions, flowcharts, and training and process specifications.

Product audit: This type of audit is an examination of a particular product or service, such as hardware, processed material, or software, to evaluate whether it conforms to requirements (i.e., specifications, performance standards, and customer requirements).

System audit: An audit conducted on a management system. It can be described as a documented activity performed to verify, by examination and evaluation of objective evidence, that applicable elements of the system are appropriate and effective and have been developed, documented, and implemented in accordance and in conjunction with specified requirements.

A ***quality management system audit*** evaluates an existing quality management program to determine its conformance to company policies, contract commitments, and regulatory requirements.

Similarly, an ***environmental system audit*** examines an environmental management system, a ***food safety system audit*** examines a food safety management system, and ***safety system audits*** examine the safety management system.

Audit Considerations:

Other methods, such as a desk or document review audit, may be employed independently or in support of the three general types of audits.

Some audits are named according to their purpose or scope. The scope of a department or function audit is a particular department or function. The purpose of a management audit relates to management interests, such as assessment of area performance or efficiency.

An audit may also be classified as internal or external, depending on the interrelationships among participants. Internal audits are performed by employees of your organization. External audits are performed by an outside agent. Internal audits are often referred to as first-party audits, while external audits can be either second-party or third-party.

WHAT ARE FIRST-PARTY, SECOND-PARTY, AND THIRD-PARTY AUDITS?

A **first-party audit** is performed within an organization to measure its strengths and weaknesses against its own procedures or methods and/or against external standards adopted by (voluntary) or imposed on (mandatory) the organization. A first-party audit is an internal audit conducted by auditors who are employed by the organization being audited but who have no vested interest in the audit results of the area being audited.

A second-party audit is an external audit performed on a supplier by a customer or by a contracted organization on behalf of a customer. A contract is in place, and the goods or services are being, or will be, delivered. Second-party audits are subject to the rules of contract law, as they are providing contractual direction from the customer to the supplier. Second-party audits tend to be more formal than first-party audits because audit results could influence the customer's purchasing decisions.

A **third-party audit** is performed by an audit organization independent of the customer-supplier relationship and is free of any conflict of interest. Independence of the audit organization is a key component of a third-party audit. Third-party audits may result in certification, registration, recognition, an award, license approval, a citation, a fine, or a penalty issued by the third-party organization or an interested party.

THANK YOU