

# **MAA OMWATI DEGREE COLLEGE** **HASSANPUR(PALWAL)**

## **EXAM NOTES**

**CLASS – B.COM 4<sup>th</sup> SEM (NEP)**

**SUBJECT – AUDITING**

**CODE -25COM1404DS03**

## **UNIT-I**

Auditing is essentially the "quality control" of the financial world. It's the process of having an independent expert look over a company's books to make sure everything is accurate and honest. Think of it as a formal "check-up" for a business's financial health.

### **1. Meaning of Auditing**

Auditing is the systematic and independent examination of data, statements, records, operations, and performances of an enterprise for a stated purpose. An auditor perceives and recognizes the propositions before them for examination, collects evidence, evaluates the same, and on this basis, formulates a judgment which is communicated through their audit report.

### **2. Objectives of Auditing**

The goals of an audit are generally split into two categories:

#### **Primary Objective**

- Expression of Opinion: To determine if the financial statements present a "True and Fair" view of the financial position and operating results of the organization.

#### **Secondary Objectives**

- Detection and Prevention of Fraud: Identifying intentional misrepresentations or theft.

- **Detection and Prevention of Errors:** Catching unintentional mistakes like clerical errors or errors of principle.
- **Compliance:** Ensuring the business follows relevant laws and regulations.

### 3. Basic Principles of Auditing

Governed by professional standards, these principles ensure the auditor remains credible:

1. **Integrity, Objectivity, and Independence:** The auditor must be straightforward, honest, and free of any interest in the business they are auditing.
2. **Confidentiality:** Information acquired during the audit cannot be disclosed without proper authority.
3. **Skills and Competence:** The audit must be performed by people with adequate training and experience.
4. **Work Performed by Others:** When an auditor delegates work to assistants or uses work performed by other auditors/experts, they continue to be responsible for forming an opinion.
5. **Documentation:** Auditors must document matters which are important in providing evidence that the audit was carried out properly.

### 4. Techniques of Auditing

These are the methods auditors use to gather evidence:

- **Vouching:** Examining documentary evidence (invoices, receipts) to support transactions.
- **Physical Examination:** Physically counting cash, inventory, or inspecting fixed assets.
- **Confirmation:** Getting a written response from a third party (like a bank or a customer) to verify account balances.
- **Inquiry:** Asking questions of management or employees.
- **Analytical Procedures:** Comparing current financial data with prior periods or industry trends to spot inconsistencies.

### 5. Classification of Audit

Audits can be classified based on various criteria:

Basis	Types
By Authority	Statutory Audit (Required by law) vs. Voluntary Audit (Done by choice).

<b>Basis</b>	<b>Types</b>
<b>By Timing</b>	<b>Continuous Audit</b> (Year-round) vs. <b>Final/Periodic Audit</b> (End of year) vs. <b>Interim Audit</b> (Middle of year).
<b>By Scope</b>	<b>Complete Audit</b> vs. <b>Partial Audit</b> .
<b>By Object</b>	<b>Internal Audit</b> (By employees for management) vs. <b>External Audit</b> (By outsiders for stakeholders).
<b>Special Types</b>	<b>Cost Audit, Management Audit, Tax Audit, and Social Audit.</b>

Audit planning is the roadmap for an audit. Before an auditor starts "vouching" or counting cash, they must understand the systems the company has in place to prevent errors. These systems fall under the umbrella of Internal Control, which is supported by Internal Check and Internal Audit?

## 1. Internal Control

Internal Control is the whole system of controls, financial and otherwise, established by management. It's the "big picture" strategy to ensure the business runs efficiently, assets are safe, and records are accurate.

- **Objective:** To ensure the business follows policies and protects its resources.
- **Scope:** Includes everything from password protections on computers to who is allowed to sign a check.

## 2. Internal Check

Internal Check is a **subset of internal control**. It is a system where the work of one person is automatically checked by another person during the normal course of business.

- **The Logic:** No single person should have total control over all parts of a transaction. For example, the person who records a sale should not be the same person who collects the cash.
- **Key Feature:** It is continuous and happens "live" as transactions occur. It relies on the **division of labor**.

### 3. Internal Audit

Internal Audit is an **independent appraisal activity** within an organization. It's like having an "in-house detective" or consultant who reviews the internal controls and internal checks to see if they are actually working.

- **The Logic:** Management needs to know if their rules are being followed and if those rules are effective.
- **Key Feature:** Unlike internal check (which is part of the daily workflow), internal audit is a **separate review** that happens after the work is done.

#### Comparison Table: Check vs. Audit

Feature	Internal Check	Internal Audit
Nature	It is an arrangement of duties.	It is a review of operations and records.
Timing	Happens simultaneously with the work.	Happens after the work is completed.
Objective	To prevent errors and frauds.	To detect errors and frauds and suggest improvements.
Personnel	Performed by the regular operating staff.	Performed by specially appointed internal auditors.
Thrust	Focuses on "doing the work correctly."	Focuses on "verifying the work was done correctly."

#### The Audit Planning Process

When an auditor plans their work, they follow these steps:

1. **Understand the Business:** Learn the client's industry and legal environment.
2. **Evaluate Internal Control:** The auditor tests the "Internal Check" and "Internal Audit" systems.
  - *If controls are strong:* The auditor can do less detailed testing.

- *If controls are weak:* The auditor must do a very deep, 100% check of transactions.
- 3. **Develop an Audit Program:** A detailed list of instructions for the audit team.
- 4. **Determine Timelines:** Decide when to perform specific tasks (e.g., inventory count at year-end).

## UNIT-II

Audit procedures are the specific steps and methods auditors use to obtain evidence. Think of this as the "investigative phase" where the auditor moves from planning to execution.

### 1. Routine Checking

This is the most basic level of auditing. It involves the mathematical verification of the books of account.

- **What it involves:** Checking the accuracy of additions (footing), carry-forwards, and postings from journals to ledgers.
- **Purpose:** To ensure that the books are arithmetically correct and that no simple clerical errors have occurred.

### 2. Vouching

Vouching is often called the "**Backbone of Auditing.**" It is the examination of documentary evidence (vouchers) to support the transactions recorded in the books.

- **The Process:** An auditor selects a transaction in the books and traces it back to the original document (e.g., an invoice, a receipt, or a contract).
- **Objective:** To ensure transactions are **authentic**, authorized, and properly recorded.

### 3. Verification vs. Valuation

While these terms are often used together, they represent different stages of checking an asset or liability.

#### Verification

Verification is the process of substantiating the existence, ownership, and possession of items in the balance sheet.

- **Physical Verification:** Seeing the asset (e.g., counting inventory or inspecting a building).
- **Legal Verification:** Checking title deeds or registration papers to ensure the company actually owns it.

## Valuation

Valuation ensures that assets and liabilities are recorded at the **correct monetary value** according to accounting standards (e.g., Cost price or Market value, whichever is lower).

- **The Auditor's Role:** The auditor is not an appraiser, but they must ensure the valuation method used by management is consistent and mathematically accurate.

## 4. Special Categories: Assets & Liabilities

### Intangible Assets

These are assets you cannot touch (e.g., Goodwill, Patents, Trademarks, Copyrights).

- **Procedure:**
  - Examine purchase agreements or legal certificates.
  - Verify the **Amortization** (gradual write-off) schedule.
  - Check for "Impairment" (if the asset has lost its value significantly).

### Contingent Liabilities

These are potential liabilities that may or may not occur, depending on the outcome of an uncertain future event (e.g., a pending lawsuit or a bank guarantee).

- **Procedure:**
  - Review minutes of board meetings.
  - Obtain a **Legal Confirmation Letter** from the company's lawyers.
  - Ensure they are disclosed in the "Notes to Accounts" rather than as a hard number in the balance sheet.

## Summary Table: Verification & Valuation

Item	Verification Technique	Valuation Basis
<b>Fixed Assets (Land)</b>	Inspection of Title Deeds	Historical Cost (usually)
<b>Inventory</b>	Physical count/Stocktaking	Lower of Cost or Net Realizable Value

Item	Verification Technique	Valuation Basis
<b>Intangible (Patents)</b>	Inspection of Registration Certificate	Cost less Amortization
<b>Liabilities (Loans)</b>	Bank Confirmation Letters	Amount Outstanding + Accrued Interest

## UNIT-III

In most jurisdictions (such as under the Companies Act in India or the UK), the rules governing company auditors are strict to ensure they remain independent watchdogs for the shareholders.

### 1. Qualification & Disqualification

To be a company auditor, one must meet specific professional and legal criteria.

- **Qualifications:** Generally, a person must be a **Chartered Accountant (CA)** or a **Certified Public Accountant (CPA)** holding a valid certificate of practice. A firm can also be appointed if the majority of partners are practicing in the relevant jurisdiction.
- **Disqualifications:** A person cannot be an auditor if they have a conflict of interest. This typically includes:
  - An officer or employee of the company.
  - A person who is indebted to the company (e.g., owes them a large loan).
  - A person whose relative is a director or key managerial personnel in the company.
  - A person who provides "prohibited services" like bookkeeping or investment banking to the same client.

### 2. Appointment of Auditors

The power to appoint an auditor shifts depending on the stage of the company:

- **First Auditor:** Usually appointed by the **Board of Directors** within 30 days of registration. If they fail, the shareholders appoint them at an Extraordinary General Meeting (EGM).
- **Subsequent Auditors:** Appointed by the shareholders at the **Annual General Meeting (AGM)**. They typically hold office from the conclusion of that AGM until the conclusion of the sixth AGM (a 5-year term).

- **Casual Vacancy:** If an auditor resigns, the Board usually fills the vacancy, but the shareholders must approve it.

### 3. Powers and Duties

The law grants auditors specific "weapons" to do their job and imposes "obligations" to protect the public.

#### Powers (Rights)

- **Right of Access:** Access at all times to the books, accounts, and vouchers of the company.
- **Right to Information:** To require from officers any information or explanation necessary for the performance of duties.
- **Right to Attend General Meetings:** To receive notices of and attend any general meeting (AGM/EGM).
- **Right to Sign Audit Reports:** Only the auditor can sign the report or financial documents.

#### Duties

- **Duty to Report:** To state whether the financial statements show a "**True and Fair**" view.
- **Duty of Inquiry:** To specifically check if loans are properly secured and if personal expenses are charged to the revenue account.
- **Duty to Comply with Auditing Standards:** To follow the official professional guidelines (SAs or ISAs).
- **Duty to Report Fraud:** If the auditor finds evidence of a significant fraud, they are often legally mandated to report it to the Central Government or regulatory bodies.

### 4. Liabilities of a Company Auditor

If an auditor is negligent or dishonest, they face serious consequences:

1. **Civil Liability:** Liability for **Negligence** (if they fail to exercise reasonable care, causing loss to the company) and **Breach of Trust** (Misfeasance).
2. **Criminal Liability:** If the auditor willfully makes a false statement in a report or helps in concealing fraud, they can face imprisonment and heavy fines.
3. **Professional Misconduct:** Their professional body (e.g., ICAI or AICPA) can cancel their license to practice.

### 5. Audit Committees

In large or listed companies, an **Audit Committee** acts as a bridge between the external auditor and the Board of Directors.

- **Composition:** Usually consists of at least three directors, with **Independent Directors** forming the majority. At least one member must have financial expertise.
- **Key Roles:**
  - Recommending the appointment and fee of the auditor.
  - Reviewing the auditor's independence and performance.
  - Overseeing the company's financial reporting process.
  - Reviewing internal control systems and internal audit functions.

In auditing, **Depreciation** and **Reserves** are critical areas because they involve significant management judgment. Since these aren't "cash" transactions, they are often used to manipulate profits (earnings management), making them a high-priority area for auditors.

## 1. Audit of Depreciation

Depreciation is the systematic allocation of the cost of a tangible asset over its useful life. The auditor's goal is to ensure the amount charged is reasonable and consistent.

### Audit Objectives

- To ensure the method of depreciation is appropriate for the asset type.
- To verify that the calculations are mathematically accurate.
- To check if the depreciation complies with relevant Accounting Standards (e.g., AS 10 or IAS 16).

### Audit Procedures

1. **Consistency Check:** Verify if the method (Straight Line, Diminishing Balance, etc.) is the same as the previous year. If it changed, there must be a valid reason and a disclosure note.
2. **Examination of Assets:** Ensure depreciation is only charged on assets **owned and used** by the company. Land generally does not depreciate.
3. **Verification of Life and Residual Value:** Evaluate if the "useful life" and "salvage value" estimated by management are realistic based on industry standards.
4. **Recalculation:** The auditor should perform an independent "re-computation" of depreciation for a sample of assets to test mathematical accuracy.
5. **Period Check:** Ensure depreciation is charged from the date the asset was "ready for use," not necessarily when it started being used.

## 2. Audit of Reserves

Reserves are profits set aside to strengthen the company's financial position or to meet specific future liabilities. Unlike provisions, reserves are an **appropriation of profit**, not a charge against it.

### Classification for Audit

- **Revenue Reserves:** Created out of profits earned from normal business operations (e.g., General Reserve). These are available for distribution as dividends.
- **Capital Reserves:** Created out of capital profits (e.g., Profit on sale of fixed assets, Premium on issue of shares). These are usually not available for dividends.

## Audit Procedures

1. **Authorization:** Check the **Articles of Association (AOA)** and Board minutes to see if the creation of the reserve was properly authorized.
2. **Classification:** Ensure that Revenue Reserves and Capital Reserves are not mixed up. Capital profits should ideally not be used to pay dividends.
3. **Utilization:** Verify that reserves were used only for their intended purposes. For example, a "Debenture Redemption Reserve" must be used only to pay back debentures.
4. **Disclosure:** Ensure that all reserves are clearly shown under the "Reserves and Surplus" head in the Balance Sheet.
5. **Specific Reserves:** For Statutory Reserves, ensure the company has transferred the minimum percentage required by law (e.g., Banking or Insurance laws).

## Key Difference: Provision vs. Reserve

As an auditor, it is crucial to distinguish between these two:

Feature	Provision	Reserve
<b>Nature</b>	A charge against profit (reduces net profit).	An appropriation of profit (divides net profit).
<b>Purpose</b>	To meet a <b>known</b> liability (e.g., Bad debts).	To strengthen the financial position for <b>unknown</b> future needs.
<b>Necessity</b>	Mandatory, even if there is a loss.	Created only if there is a profit.
<b>Placement</b>	Usually deducted from assets or shown as a liability.	Shown under "Reserves & Surplus" in Equity.

Auditing specialized industries requires a shift from general verification to checking compliance with specific statutes. Each of these sectors has unique "red flags" and regulatory frameworks.

## 1. Audit of Private Sector Companies

Private companies (typically limited by shares) are governed by general corporate laws (like the Companies Act). The focus here is on owner-management dynamics and tax compliance.

- **Internal Controls:** In smaller private companies, "management override" is a risk. Auditors focus on whether the owners are mixing personal expenses with business accounts.
- **Share Capital:** Verify that shares were issued according to the Articles of Association and that the "Register of Members" is up to date.
- **Related Party Transactions:** Private firms often deal with sister concerns. Auditors must ensure these transactions are at "**Arm's Length**" (fair market price) and properly disclosed.
- **Director's Remuneration:** Check that the pay and perks given to directors stay within legal limits.

## 2. Audit of Banking Companies

Banking audits are high-risk and focus heavily on the **existence of assets** (loans) and **liquidity**.

- **NPA Classification:** This is the most critical part. The auditor must check if loans are "performing" or "non-performing" based on the number of days the interest/principal is overdue (typically 90 days).
- **Verification of Advances:** Ensure that loans are backed by sufficient collateral (security) and that the documents are legally enforceable.
- **CRR and SLR:** Verify that the bank is maintaining the mandatory **Cash Reserve Ratio** and **Statutory Liquidity Ratio** as required by the Central Bank (e.g., RBI or Federal Reserve).
- **Revenue Recognition:** Banks cannot record interest income on NPAs unless the cash is actually received.
- **Inter-branch Reconciliation:** Banks have thousands of daily entries between branches; auditors check for long-pending "reconciled" entries which could hide fraud.

## 3. Audit of Insurance Companies

Insurance accounting is unique because they collect money now for a potential "event" later. The audit focuses on **claims** and **reserves**.

- **Premium Verification:** Ensure premiums are recognized as income only when the risk commences. Auditors check the "Premium Register" against bank statements.
- **Claims Settled & Outstanding:**
  - **Settled:** Verify the validity of the claim and the discharge voucher signed by the policyholder.
  - **Outstanding:** Ensure that a provision is made for claims that have happened but haven't been paid yet (**IBNR** - Incurred But Not Reported).
- **Commission to Agents:** Verify that commissions paid to agents do not exceed the legal limits and are calculated accurately based on the premium collected.

- **Reinsurance:** Check the "Reinsurance Ceded" (insurance the company bought for itself) to ensure the risk and premium are correctly split with the reinsurer.
- **Investment Compliance:** Insurance companies handle public money; auditors must ensure investments follow strict government safety guidelines (e.g., investing in government bonds).

### Comparison of Key Audit Focus

Feature	Banking Company	Insurance Company
<b>Primary Asset</b>	Loans and Advances.	Investments and Reinsurance assets.
<b>Primary Liability</b>	Customer Deposits.	Policy Reserves and Unpaid Claims.
<b>Key Regulation</b>	Banking Regulation Act.	Insurance Act / IRDAI Guidelines.
<b>Critical Risk</b>	Bad Debts (NPAs).	Under-provisioning of future claims.

## UNIT-IV

The Audit Report is the final product of the entire auditing process. It is the formal document through which the auditor communicates their opinion on whether the financial statements represent a "true and fair" view of the entity's financial health.

### 1. Objectives of an Audit Report

The primary purpose is not just to "check math," but to provide **assurance** to stakeholders (shareholders, banks, government).

- **Expression of Opinion:** To state clearly if the financial statements are reliable.
- **Compliance Verification:** To confirm if the accounts were prepared following GAAP, IFRS, or relevant national standards.
- **Statutory Requirement:** To fulfill the legal obligation of reporting to the owners (shareholders) about the management's performance.
- **Information to Third Parties:** To help creditors and investors make informed decisions.

### 2. Basic Contents of an Audit Report

While formats vary by country, most follow a standard structure:

1. **Title:** Usually "Independent Auditor's Report."
2. **Addressee:** Typically the Shareholders or the Board of Directors.
3. **Opinion Section:** This is now often placed at the beginning, stating the auditor's conclusion.
4. **Basis for Opinion:** Mentions that the audit was conducted according to Auditing Standards.
5. **Key Audit Matters (KAM):** Highlights areas that were most significant in the audit (common in listed companies).
6. **Management's Responsibility:** States that management is responsible for preparing the accounts and internal controls.
7. **Auditor's Responsibility:** Explains that the auditor's job is to obtain "reasonable assurance" (not a 100% guarantee).
8. **Signature, Place, and Date.**

### 3. Types of Audit Reports (The Opinions)

The "flavor" of the report depends on what the auditor found during their investigation.

#### A. Unqualified Report (Clean Report)

The auditor is satisfied that the financial statements are fair, accurate, and comply with all regulations. This is the "Gold Standard."

#### B. Qualified Report ("Except For...")

The auditor finds that most of the financial statements are correct, **except for** one or two specific items.

- *Example:* Everything is fine, except the company didn't calculate depreciation correctly for its machinery.

#### C. Adverse Report

The auditor determines that the financial statements are **misleading or dishonest**. There are widespread (pervasive) errors or frauds. This is a massive "red flag."

#### D. Disclaimer of Opinion

The auditor is **unable to form an opinion**. This happens if the company's records are destroyed (e.g., a fire) or if management refuses to provide the necessary information.

### 4. Qualifications in an Audit Report

In auditing terminology, a "**Qualification**" is a reservation or a disagreement. When an auditor "qualifies" their report, they are effectively saying, "I have a problem with this specific part of the accounts."

- **Reasons for Qualifications:**
  - Non-compliance with Accounting Standards.
  - Inadequate disclosure of important information.
  - Disagreement with management over the valuation of assets.
  - Inability to verify a significant amount of inventory.

## Difference between "Qualified" and "Unqualified"

It is often confusing to students:

- **Unqualified** = Good (No "buts" or "ifs").
- **Qualified** = Needs Attention (The auditor has "reservations").

## Summary Table: Impact of Errors on Report Type

Nature of Issue	Material (Isolated)	Pervasive (Widespread)
<b>Financial Misstatement</b>	Qualified Opinion	Adverse Opinion
<b>Inability to get Evidence</b>	Qualified Opinion	Disclaimer of Opinion

While a general audit is a routine check-up, an investigation is more like a forensic inquiry—it is a "special audit" conducted for a specific purpose.

## 1. Investigation: Nature and Objectives

An investigation involves a critical examination of the books of accounts for a specific reason, often spanning several years.

### Nature

- **Specific and Targeted:** Unlike an audit, which covers all financial aspects, an investigation focuses only on the area of concern.
- **No Fixed Period:** It doesn't follow the "financial year" rule; it can cover 3 to 5 years if necessary.
- **Evidence over Verification:** It requires "conclusive" evidence rather than just "persuasive" evidence.

- **Not Mandatory:** Investigations are usually initiated by management, owners, or third parties (like banks), though some are ordered by the government.

## Objectives

- **Fraud Detection:** To identify how a fraud occurred and who was responsible.
- **Purchase of Business:** To verify the assets, liabilities, and earning capacity before an acquisition.
- **Lending:** To help a bank determine if a borrower is capable of repaying a large loan.
- **Admission of Partner:** To ensure the existing firm's value is correctly stated before a new partner joins.

## 2. Specialized Audits

These audits go beyond the standard "True and Fair" view to look at compliance, efficiency, and cost-effectiveness.

### A. Tax Audit

- **Meaning:** A review of a business's accounts to ensure they comply with the Income Tax laws.
- **Objective:** To verify that income, expenses, and deductions are reported accurately, making the tax official's job easier.
- **Requirement:** In many regions (like India under Section 44AB), it is mandatory if the business turnover exceeds a certain threshold.

### B. Management Audit

- **Meaning:** An appraisal of the **performance and efficiency** of the management team.
- **Objective:** To identify "bottlenecks" in the decision-making process and suggest improvements for operational efficiency.
- **Focus:** It asks, "Are the managers using the company's resources wisely?" rather than "Are the books balanced?"

### C. Cost Audit

- **Meaning:** The verification of cost records and the cost accounting plan.
- **Objective:** To ensure that the cost of production is correctly calculated and that there is no wastage of materials or labor.
- **Focus:** Often mandatory for industries like mining, manufacturing, and utilities.

## 3. Auditing and Assurance Standards (SAs)

To ensure that all auditors work with the same level of quality, professional bodies (like the IAASB or ICAI) issue **Standards on Auditing (SAs)**.

## Key Standards to Know

Standard	Name/Topic	What it covers
SA 200	Overall Objectives	The auditor's basic goals and the concept of "Ethical Requirements."
SA 230	Audit Documentation	The "Working Papers" that prove the auditor actually did the work.
SA 240	Auditor's Responsibilities for Fraud	How to react when a fraud is suspected during an audit.
SA 300	Planning an Audit	The roadmap for conducting an efficient audit.
SA 500	Audit Evidence	What counts as "good" evidence (Reliability, Sufficiency).
SA 700	Forming an Opinion	How to draft the final Audit Report.

## 4. Audit vs. Investigation: The Key Differences

Feature	Audit	Investigation
Scope	General review of financial statements.	Specific and restricted to a certain area.
Objective	To see if books are "True and Fair."	To find the "fact" behind a suspicion or need.
Evidence	Persuasive (Checks if things look okay).	Conclusive (Proves things one way or another).

<b>Feature</b>	<b>Audit</b>	<b>Investigation</b>
<b>Preformed by</b>	External Auditor (Chartered Accountant).	Any expert or firm (not necessarily the auditor).