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CHAPTER

TYPES OF AUDIT

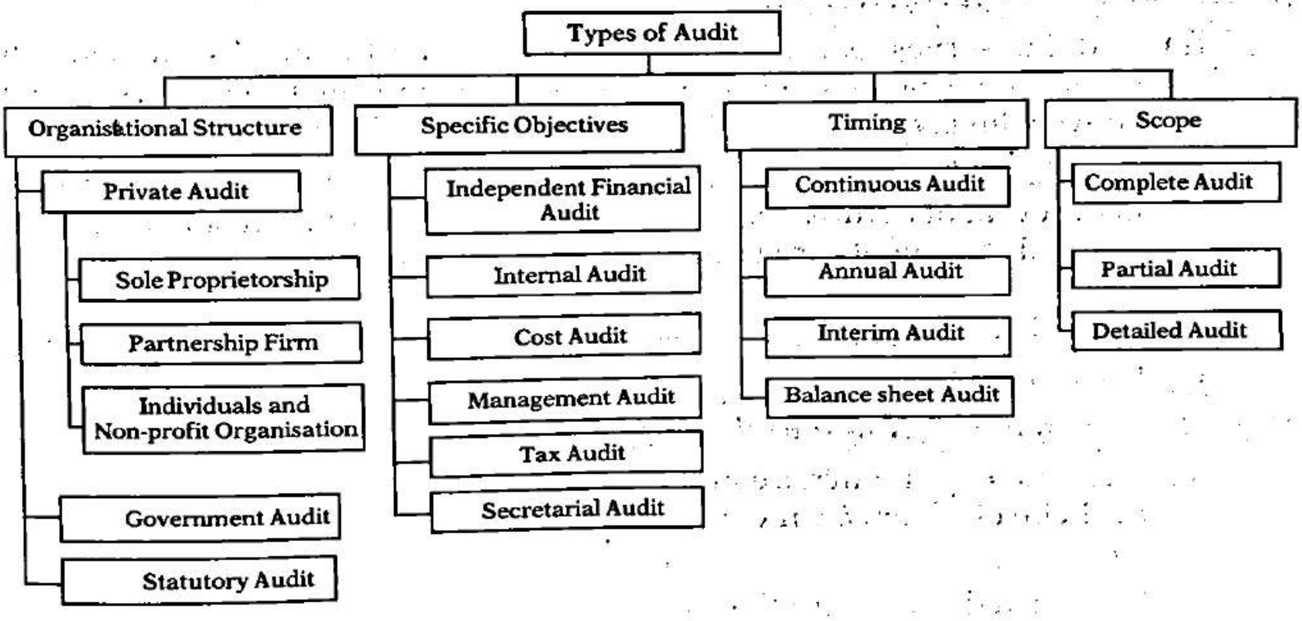
Introduction

2.1 Auditing, as already stated earlier, refers to any evaluation process carried out systematically for a defined purpose and resulting in an opinion, which is communicated to the interested parties through a report.

This definition of auditing is sufficiently broad to encompass various types of audit. Different basis can be adopted to classify audits to gain a better understanding of their characteristic features. The following chart shows different types of audit:

FIGURE 2.1

BASIS OF CLASSIFICATION OF AUDIT



Classification on the basis of organisational structure

Private audit

2.2-1 Private audits are carried out at the behest of the interested parties and not to fulfil statutory requirements. The terms and conditions between the client and the auditor defines the scope of latter's work. Sole proprietors, partnership firms, certain individuals such as rent collectors, estate managers, doctors, architects, etc. and non-profit organisations such as schools, hospitals, clubs, etc., get the accounts audited for various reasons. Some of these are to meet the requirements laid down by internal rules and regulations, to ensure reliability of financial statements and derive related advantages. These advantages are listed below :

(i) Advantages to sole proprietor

(*a*) Auditing ensures the proprietor of the reliability of the books of account maintained by the accountant and financial statements drawn therefrom by him.

(*b*) Audited accounts are helpful in certain situations, for example, for settling insurance claims, for obtaining loan from banks, for settling tax liability disputes, etc.

(*c*) Uniform accounting policies are adopted year after year if accounts are to be audited. This helps the proprietor to compare financial statements of one year with the other.

(ii) Advantages to partnership firm

(*a*) Auditing serves as a basis for reliance on the financial statements. It assumes special significance in those cases where all the partners are not actively involved in managing the affairs of the business.

(*b*) Auditing helps in avoiding/solving possible disputes among the partners in the event of admission, retirement, death or dissolution of partnership. Audited statements are used as a basis for valuation of goodwill in such cases.

(*c*) It helps in dealing with third parties such as banks, insurance companies, Government, etc.

(iii) Advantages to individual and non-profit organisation

(*a*) The audited statements can serve as a basis for relying on the persons at the helm of affairs *i.e.*, members of governing body or managing committee.

(*b*) It helps in dealing with third parties.

(*c*) It helps in protecting the assets and ascertaining the liabilities.

(*d*) It helps them to meet internal requirement of getting accounts audited.

(*e*) NPOs, generally, enjoy Government grants. They require audited accounts for availing these grants.

Sole proprietors, partnership firms, individuals and non-profit organisations having turnover/receipts exceeding a specified limit are required to get a tax audit of their accounts under the Income-tax Act, 1961. (Refer to Paragraph 15.2-1)

2.2-2 Government audit

- *MEANING AND SCOPE* - Government audit is a control measure for public accounting of Government funds. It covers the audit of all expenditure and receipts done by the executive and audit of commercial accounts maintained by public enterprises. Public enterprises are classified under three categories—departmental undertaking, statutory corporations financed by Government and Government companies set up under the Companies Act, 2013.
- *WHO CONDUCTS IT* - In India, the Accounts and Audit Department of the Government of India, headed by the Comptroller and Auditor General of India (CAG), carries the audit work. The CAG's duties have been specified by the Comptroller and Auditor General's (Duties, Powers and Condition of Service) Act, 1971 and can be classified as under -
  - (*i*) To audit the receipts and expenditures of the Union and State Governments alongwith departmental undertakings.
  - (*ii*) To audit the accounts of statutory bodies or corporations depending upon the nature of statute governing them.
  - (*iii*) To audit the accounts of the Government companies in accordance with the provisions of the Companies Act, 2013. In case of Government companies, as per the provisions of the Companies Act, 2013, the CAG appoints the statutory audit. However, he has the power to give directions to such auditors for reporting on specific aspects of their audit work and to conduct supplementary test audit of accounts.
- *SUBMISSION OF AUDIT REPORT*
  - (*i*) The audit reports of the CAG on the accounts of the Union or States and certified Finance and Appropriation Accounts are submitted to the President or Governor for being laid before Parliament or State Legislature. These audit reports include matters such as wasteful expenditure, non-observance of rules, cases of financial impropriety, etc.
  - (*ii*) The reports of the CAG on public enterprises of the Central Government are presented to Parliament and of the State Governments, to respective State Legislature.

Statutory audit

2.2-3 An audit which is authorised, governed and made compulsory under any statute is called statutory audit. Various aspects concerning audit of accounts such as scope of audit, qualifications of an auditor and his rights, duties and liabilities and other details are mentioned in the statute itself. Some such examples are :

(*i*) The Companies Act, 2013 covering audit of limited companies incorporated under it.

(*ii*) The Banking Regulation Act, 1949 applicable to audit of banking companies.

(*iii*) The Insurance Act, 1938 governing audit of insurance companies.

(*iv*) The Electricity (Supply) Act, 1948 governing audit of electricity boards/companies.

(*v*) Cooperative Societies Act and Public and Charitable Trust Act of various states dealing with audit of these entities.

2.2-4 Distinction between audit of a limited company and audit of a firm

(*i*) **Statutory requirement**

- The audit of limited companies is *governed by statute i.e.* the Companies Act, 2013 (hereinafter referred to as the Act).
- The audit of a firm is governed by *specific instructions* from the client and partnership deed (if any).

(*ii*) **Scope**

- The rights and duties of statutory auditor *cannot be restricted* by the Articles [*Newton* v. *Birmingham Small Arms Co. Ltd.* (1906)] or in any other manner. Auditor must conform to requirements of the Act.
- The scope of work of auditor of a firm may be *varied, enlarged or restricted* by proprietor or partners.

(*iii*) **Appointment of auditor**

- The auditor, in case of limited companies, is appointed by the shareholders in general meeting. But in specific cases the board of directors, or the Comptroller and Auditor General may appoint the auditor.
- In case of a firm, sole proprietor/partners appoint the auditor.

(*iv*) **Accounting treatment and disclosure of various items of financial statements**

- In the former case, such treatment and disclosure should be *in accordance with the Act.*

- In the case of a firm, treatment and disclosure depends upon *specific instructions of the client.* But the auditor should keep in consideration *recognised accounting principles* and standard auditing practices while dealing with various items of financial statements.

(v) **Report**

- A statutory auditor has to submit his report *to the shareholders* of a company in accordance with the requirements of the Companies Act, 2013.
- An auditor of a firm should report or certify in accordance with *the terms of his appointment.*

Classification on the basis of specific objectives

2.3-1 Independent financial audit -

- *Object* - Independent financial audit is conducted for the purpose of ascertaining whether the balance sheet and profit and loss account of a business give a true and fair view of the operations and working results of a business respectively.
- *Conducted by* - It is conducted by professionally qualified auditors for clients who may be sole proprietors, partners, various individuals, members of non-profit organisations and shareholders.
- *Statutory status* - Independent financial audit has been made compulsory for many entities established under respective Acts.
- *Reports* - The auditor is required to submit his report to the client which is a useful document for third parties as well.

2.3-2 Internal audit -

- *Definition* - Internal audit has been defined by the Preface to the Standards and Guidance Notes on Internal Audit issued by the ICAI as, "an independent management function which involves a continuous and critical appraisal of the function of the entity. The objective of internal audit is to suggest improvement to the function of the entity and add value to and strengthen the overall governance mechanism of the entity including strategic risk management and internal control system."
- *Statutory status* - Under section 138 of the Companies Act, 2013 internal audit has been made mandatory for the class of limited companies required by the Central Government to do so.

Independent audit v. Internal audit

2.3-3 The differences between independent audit and internal audit have been listed below :

(i) **Object** - The object of independent financial audit is to *ascertain the truthfulness and fairness of state of affairs* of an entity while the object of internal audit is to *review financial and non-financial operations* as a service to management.

(ii) **Appointment of auditor** - Independent audit is conducted by a qualified auditor appointed by the *owners or shareholders* of the entity. On the other hand, an internal auditor, who is generally an employee of the organisation, is appointed by the *management*. It may be noted that though an employee, an internal auditor should approach his work independently.

(iii) **Submission of report** - Independent financial auditor submits his report to *the owners* or *shareholders*. But an internal auditor submits his report to *management*.

(iv) **Duties** - Duties of an independent financial auditor are fixed by *statute* or by *engagement letter* whereas *management* decides the duties of an internal auditor.

(v) **Responsibility for detection and prevention of frauds and errors** - In case of independent audit, auditor is *incidentally concerned* with the detection and prevention of those frauds and errors which affect financial statements materially. On the other hand, internal auditor is *directly concerned* with the detection and prevention of frauds and errors.

(vi) **Periodicity** - Independent audit may be conducted on *an annual* or *on a continuous basis*. But internal auditor reviews the operations of a company *continuously i.e.*, throughout the year.

2.3-4 Cost audit -

- *Definition* - Cost audit is the verification of the correctness of cost accounts and of adherence to the cost accounting plan.
- *Statutory status* - Section 148 of the Companies Act, 2013 has made cost audit mandatory for some limited companies.

2.3-5 Management audit -

- *Meaning and definition* - Management audit is an audit to examine, review and appraise the various policies and actions of the management on the basis of certain standards. It goes beyond the conventional audit which lays emphasis on scrutiny of financial transactions and the books of account only. Management audit is a comprehensive and critical review of all aspects of management performance.

- *Statutory status* - It is not compulsory under any law. The shareholders or board of directors may appoint the management auditor.

2.3-6 Tax audit -

- *Definition* - Tax audit can be defined as an examination of financial records to assess the correctness of calculation of taxable profit, to ensure compliance with provisions of the Income-tax Act, 1961 and also to ensure fulfilment of conditions for claiming deductions under the said Act.
- *Statutory status* - The Income-tax Act has made tax audit compulsory for specified persons under section 44AB. The Assessing Officer has been empowered under section 142(2A) to direct the assessee to get his accounts audited by an 'accountant' nominated by the Commissioner of Income-tax.

Secretarial audit

2.3-7 Secretarial audit is an audit to examine compliance of various legislations applicable to the entity by a practising company secretary duly appointed by Board of Directors.

Applicability of Secretarial audit- Section 204	◆ All Listed Companies. ◆ Every public company having paid up share capital of 50 crore rupees or more, or ◆ Every public company having a turnover of 250 crore rupees or more
Who should conduct it	◆ Practising Company Secretary in respect of secretarial and other records of the company.
Report submission	◆ Secretarial audit report to be annexed to the Board report. It should be submitted before the preparation of Board's Report.
Duty of the company	◆ To give all assistance and facilities to the Company Secretary in Practice, for auditing the secretarial and related **records of the company**
Action on BOD's part	◆ Board of Directors, in their report, shall explain in full, any qualification or observation or other remarks made by the Company Secretary in practice in audit report;
Functions of Company Secretary	The functions of the company secretary shall include— 1. to report to the Board about compliance with the provisions of the Act, the rules made thereunder and other laws applicable to the company;

	2. to ensure that the company complies with the applicable secretarial standards; and 3. to discharge such other duties as may be prescribed
Duties of Company Secretary	Same as that of statutory audit

Classification on the basis of time

2.4-1 Continuous audit

- CONCEPT - According to ***R.C. Williams***

  "A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular or irregular intervals during the period."

  The following features of continuous audit come to light on analysis of the above definition—

  (*a*) It is carried throughout the year.

  (*b*) It is conducted at regular or irregular intervals.

  (*c*) The accounts are subjected to scrutiny as and when prepared.

  (*d*) Full verification of assets and liabilities is left until the balance sheet is prepared. However, some assets like cash balances and inventory may be verified at every visit by the auditor.

  (*e*) Trial balance, profit and loss account and balance sheet are audited at the end of the year.

- SUITABILITY - The nature of continuous audit is such that it is not suited for all types of organisations. It is most suited in following situations :

  (*a*) Where final accounts are to be presented immediately after the close of financial year, for example, in case of subsidiary companies.

  (*b*) Where internal controls are not very effective.

  (*c*) Where volume/number of transactions is very large.

  (*d*) Where management is interested in getting statement of accounts audited at regular intervals, for example, to know the ageing schedule of debtors and to calculate the cash balance needed for operations.

- ADVANTAGES OF CONTINUOUS AUDIT - These are as follows :

  (*a*) *Early detection of frauds and errors* - Detailed and exhaustive checking of accounts leads to quick detection of frauds and errors. Extent of fraud gets limited in case of continuous audit as compared to a situation where the defrauding party has full one year in which to operate.

(b) *Knowledge of technical details* - Continuous audit helps the auditor to understand the technicalities of business. Hence, he can advance valuable suggestions to his client for improving the system of maintaining accounts and other internal controls.

(c) *Efficiency of auditors* - Auditor, in case of continuous audit, can plan his audit work in a systematic manner. The auditor's work is more evenly spread over the year *i.e.* slack periods are filled and busy periods relieved. As a result the auditor, who has a number of such audit assignments, avoids a situation in which additional and, possibly, less trained staff has to be employed temporarily in busy periods.

Moreover, continuous audit makes it possible to present the final audited accounts to the shareholders soon after the close of financial year. The auditor, thus, can discharge his work more efficiently.

(d) *Moral check* - The fact that the auditor is visiting frequently acts as a moral check on the staff of the client.

- DISADVANTAGES OF CONTINUOUS AUDIT - The main disadvantages are as follows :

(a) *Tampering with figures* - Figures may be altered (unknowingly or fraudulently) after being checked.

(b) *Likely collusion between client's staff and auditor's staff* - Frequent interaction of the staff of the client with that of the auditor may provide scope for unhealthy relationship between the two. They might collude to perpetuate a fraud.

(c) *Losing link in audit work* - The auditor's staff may not be able to, despite caution, follow up transactions and certain queries may be left unanswered.

(d) *Dislocation of client's work* - Frequent visits of the auditor disrupt the normal flow of work. The staff of the client may divert its attention from their routine work to providing details required by the auditor.

(e) *Expensive* - The continuous audit involves detailed and exhaustive checking. The auditors, therefore, charge hefty audit fees.

- SAFEGUARDS TO BE APPLIED - The effect of disadvantages listed above may be minimised by adopting certain safeguards which are as follows :

(a) The auditor can guard himself against tampering of figures in following ways :

  - He should instruct the staff of the client to make alterations, if any, in figures that have been audited by only passing rectification entries in journal and bringing it to the notice of auditor.

- The auditor should also device special form of ticks for being placed against figures which have been altered and neither their purpose nor significance should be disclosed to client's staff.
- Totals of accounts at the end of the period under review should, if practicable, be recorded in the audit note book and verified at the next visit.

(*b*) To prevent collusion between staff of the auditor and that of client, the auditor may rotate the duties of his staff in such a manner that every audit clerk is allowed to check a particular account only for a short period.

(*c*) In order to ensure that the link in audit work is not lost :

- The auditor should prepare detailed audit programme.
- He should note down the queries, whose explanations are unsatisfactory, in his audit note book and try to sort them out at subsequent visit.
- If possible, the auditor should try to check the accounts of similar nature in one continuous sitting.

(*d*) The dislocation in client's work may be reduced if the auditor plans his visits in consultation with the client. But planned visits need to be supplemented by surprise checks.

(*e*) The biggest limitation of continuous audit is that it is quite expensive. Only big organisations should go for it after undertaking cost-benefit analysis.

2.4-2 Annual audit

- CONCEPT - Annual audit is one which is carried out only at the end of an accounting period. ***Spicer and Pegler*** have defined it as,

  "An audit which is not commenced until after end of the financial period and is then carried on until completed."

  Annual audit is also called **periodical, final** or **completed audit.**

- CHARACTERISTICS OF ANNUAL AUDIT - The main characteristics of annual audit are as follows :

  (*a*) It is done at the close of the financial year after books of account have been closed and final accounts drawn.

  (*b*) The audit work is completed in a single continuous session.

  (*c*) It gives satisfactory results in case of small concerns.

2.4-3 Continuous audit v. Annual audit

(*i*) **Nature** - Continuous audit is carried on at *regular or irregular intervals.* But the annual audit is completed in a single *continuous session* after the close of financial year.

(*ii*) **Thoroughness** - In case of continuous audit, there is a possibility of early detection of frauds and errors. The auditor is also *better acquainted* with accounting and other control systems of the entity as compared to an auditor who undertakes annual audit.

(*iii*) **Suitability** - Continuous audit is most suitable for *big organisations* or *medium sized organisations* which do not have an efficient system of internal control. On the other hand, annual audit is more suitable for *small businesses.*

(*iv*) **Verification of assets** - In case of continuous audit, the auditor *does not undertake* full verification of the assets and liabilities, *till the balance sheet is prepared* and continuous audit gets merged into the annual audit. Cash balances and inventory may, however, be verified at every visit by the auditor.

(*v*) **Detection and prevention of frauds and errors** - In case of continuous audit as they are detected *during the year* their extent is *limited* whereas in annual audit they are discovered at the *end of year.*

(*vi*) **Cost** - Continuous audit is *more expensive* than annual audit.

(*vii*) **Preparation of interim accounts** - Continuous audit helps in preparation of interim accounts while annual audit does not.

Interim audit

2.4-4 An audit conducted between two annual audits is called interim audit. It is always carried out with an interim purpose, for example, declaration of interim dividend or valuation of shares to decide swap ratio in case of a merger. Interim audit does not enjoy statutory status. However, it is generally carried out by professionally qualified auditors.

Balance sheet audit

2.4-5 The following points can be made about balance sheet audit :—

(*i*) *Origin* - Balance sheet audit is of recent origin as compared to other types of audit.

(*ii*) *Limited audit* - It means limited audit in which all the balance sheet items are verified *viz.* assets, balances of reserves and provisions, capital, profit earned or loss suffered by the firm during the year and other liabilities. Where appropriate the balances are "linked up" with the corresponding balances at the previous date, for example, changes in amount of fixed assets may be due to any one or all of the following transactions—purchase of assets, sale of assets and depreciation on assets.

- Routine audit procedures such as vouching are curtailed.

- The auditor examines the adequacy of disclosures and compliance with statutory requirements, if any.

(*iii*) *Tests are applied on items of profit and loss account* - It may be noted that balance sheet audit is not confined to balance sheet items only, wherever appropriate, tests are applied on those profit and loss account items which are directly related to the assets, for example, repair and maintenance account can be scrutinised to ascertain whether any expenditure of capital nature has been classified as revenue expense.

- The auditor can also examine the profit and loss account to see that income indicated as receivable by reference to assets (for example, dividends on investments) and expenditure appropriated to liabilities (for example, interest on bank loan) have been properly dealt with.

(*iv*) *Ascertainment of profit* - The idea of ascertainment of profits in the balance sheet audit is similar to that of the single entry system where profit is ascertained by looking at the difference between the computed totals of the net assets at the two balance sheet dates respectively and adjusting the same for any increase or decrease of capital or withdrawal of profit.

(*v*) *Suitability* - Balance sheet audit is most suitable for organisations which have an efficient system of internal control or where mechanised accounting system is in operation.

(*vi*) *Popularity* - Balance sheet audit is popular in U.S.A. But, in India, there is no distinction between final audit and balance sheet audit.

Continuous audit v. Balance sheet audit

2.4-6 The following distinctions can be made between continuous audit and balance sheet audit :

(*i*) **Nature** - In continuous audit, the auditor or his staff is *constantly engaged* in checking the accounts during the whole period *i.e.*, throughout the financial year. But in balance sheet audit, audit takes place *only at the end* of financial period.

(*ii*) **Thoroughness** - The continuous audit involves *detailed and exhaustive* checking of accounts while balance sheet audit involves *limited review* in which all the balance sheet items are verified. Tests are applied only on those items of profit and loss account which are directly related to the assets and on income/expenditure attributable to assets/liabilities.

(*iii*) **Suitability** - The continuous audit is most suited to *big organisations* and entities where *internal controls are not effective*. On the other hand, balance sheet audit is most suitable for organisations which have an *efficient system of internal control*.

(*iv*) **Verification of assets** - In both continuous as well as balance sheet audit, full verification of assets and liabilities is done at the end of the financial year. The difference in case of continuous audit is that cash and inventory records are verified by the auditor at every visit.

(*v*) **Popularity** - Continuous audit is used widely in *India, England* and other *European countries*. Balance sheet audit, on the other hand, is more popular in *America*.

Classification on the basis of scope of audit

Complete audit

2.5-1 Under this type of audit, the auditor is given unrestricted scope as to the work which he has to perform. The auditor is appointed to check all transactions, totals, balances, and books of account with the help of relevant vouchers, documents, correspondence, etc. This type of audit is neither practicable nor feasible now.

Partial audit

2.5-2 When audit is conducted on some of the records and books or a part of books for whole or part of the period, it is called partial audit. Auditor, thus, may be restricted with regards to his powers of enquiry or examination, for example, client may ask auditor to audit only payment side of cash book as he himself receives cash and cheques. In another case, client might ask the auditor to audit books of account only for the months of May and June, as he was out of India for that period. The engagement letter should clearly state the scope of auditor's work and limitations on his powers. The auditor should set out clearly the facts of the case in reporting on accounts which have been subjected only to partial audit. Partial audit is suitable only for small concerns. It does not have statutory recognition.

Detailed audit

2.5-3 Under detailed audit, few business transactions are examined in detail by the auditor. ***Spicer and Pegler*** have defined it as,

"*An audit which starts with the books of prime entry and ends with the balance sheet.* The checking sequence is arranged in order of recording the transactions in the primary book". Thus, for the purpose of detailed audit certain transactions are traced through various stages from beginning to their end with the help of available evidence. This technique of examination is also called audit-in-depth. To take an example, detailed audit of purchase of goods for inventory would consist of tracing the transaction though all the points of transaction cycle *viz*, requisitioning the goods, ordering the goods requisitioned, receiving the goods ordered and preparing the payment voucher.