



CIHAN UNIVERSITY  
SULAIMANIYA

# ***Auditing***

Cihan University – Sulaimaniya

Lecture 1 : An Introduction of Auditing

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## **CHAPTER ONE**

### **Introduction to Auditing**

During the 18th century, the company form of organizations comes into existence. In these companies capital is contributed by shareholders but they do not have control over the day today working of the company.

The shareholders who have invested their money would naturally be interested in knowing the financial position of the company. This created the need of an independent person who would check the accounts and report the shareholders on the accuracy of the accounts and the safety of their investment.

Auditing as it exists today can be associated with the emerging a joint stock company during the industrial revolution. According to the Indian Companies Act of 1956, it is mandatory for the organizations to appoint an auditor to check whether the books of account, Profit and Loss Account and Balance Sheet are showing the true and fair view of the company's business.

Nowadays, many forms of organizations are mandatorily required by the legislation (law) to get their accounts and audited. So it is important to understand the subject properly.

### **Origin of Audit (Meaning of Audit)**

The word audit is derived from the Latin word "AUDIRE" which means to hear.

Initially auditor was a person appointed by the owners to check account whenever the suspected fraud, he was to hear explanation given by the person responsible for financial transactions. Auditing was in use in all ancient countries such as Mesopotamia, Greece, Egypt, Rome, UK and India.

Emergence of joint stock companies (incorporation) changed the approach of auditing as ownership was pestered from management. The emphasis now is clearly on the verification of accounting data with a view on the reliability of accounting statements.

## **Definitions of Auditing**

This word Auditing has been defined in different ways. Some of the definitions are as follows:

1- “An audit is an examination of such records to establish their reliability and the reliability of the statement drawn from them”.

2- An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transaction to which they relate.

3- An unbiased examination and evaluation of the financial statements of an organization. It can be done internally (by employees of the organization) or externally (by an outside firm).

### **Why the need for an audit?**

The managers of the business (directors) are obliged to report to the owners (shareholders) on how their business has been managed. The owners, at this point, will like to assure themselves that the report contains no errors, it is not misleading and it discloses all relevant information.

## **Objectives of Auditing**

The objective of audit can be divided into two parts:

- 1) Primary Objectives
- 2) Secondary Objective

### **1) . Primary Objectives:-**

Determine and judge the reliability of the financial statement and the supporting accounting records of a particular financial period is the main purpose of the audit.

- 1- Verification of accounts. (The reality and validity of the transaction).
- 2- Confirming the existence and value of assets and liabilities.
- 3- Business shows true and fair state.
- 4- Profit and Loss shows true and fair state.
- 5-Following recognized accounting policies.

## 2). Secondary Objective:-

While examining the books of accounts and the relevant documents, the auditor may come across some errors and frauds. We may classify these errors and frauds as below:

**1. Detection and prevention of errors:** errors are mistakes committed unintentionally because of ignorance, carelessness. Errors are many types, such as:

**a)- Errors of Omission:** If accountant forgets to pass the journal entry of any transaction or if he records only one part of transaction, then these mistakes are called errors of omission. Accountant can also forget to post any journal entry in ledger accounts.

**b)- Errors of Commission:** If accountant passes the wrong entry or posts wrong side of ledger accounts or writes wrong amount or calculates wrong total of any account, then these types of mistakes are called errors of commission. Eg. \$1500 recorded as \$5100. Or subtracting a figure that should have been added. Some errors of commission can easy find out by making trial balance.

**c)- Compensating Errors:** when two/more mistakes are committed which counter balances each other. This error known as a Compensating Error. It happens while preparing the trial balance. Since compensating errors do not show up in the total, they are difficult to locate through statistical methods.

Eg: if the amount is wrongly debited by \$100 less and Wrongly Credited by \$100. When purchase entry of \$1000 is recorded on credit side and sales entry of \$1000 is recorded on debit side. Or when rent account is recorded \$500 less on debit side while salary account is overcast by \$500.

**d)- Error of Principle:** These are the errors committed by not properly following the accounting principles.

An accounting mistake in which an entry is recorded in the incorrect account, these arise mainly due to the lack of knowledge of accounting. Eg: Revenue expenditure may be treated as Capital Expenditure. Meaning that the value recorded was the correct value but placed incorrectly.

**2. Deduction and Prevention of Fraud:** A fraud is an Error committed intentionally to deceive/ to mislead/ to conceal the truth/ the material fact. Fraud can be divided in to three parts:

**a)- Misappropriation of Cash:** This is one of the majored frauds in any organization. It normally occurs in the cash department. This kind of fraud is either by showing more payments/ less receipt.

**b)- Misappropriation of Goods:** here records may be made for the goods that not been purchased or not been issued to production department, goods may be used for personal purpose.

**c)-Manipulation of Accounts:** this is finalizing accounts with the intention of misleading others. This is also known as “WINDOWS DRESSING”, which an action is taken to improve the appearance of a company's financial statements.

### **Location of Errors**

During the process of verifying accounts, the auditor may discover errors in the accounts. He should follow the following procedure in this regard:

- a)** Check the trial balance.
- b)** Compare list of debtors and creditors with the trial balance.
- c)** Compare the names of account appearing in the ledger with the names of accounting in the trial balance.
- d)** Check the totals and balances of all accounts and see that they have been properly shown in the trial balance.
- e)** Check the posting of entries from various books into ledger.

## **Types of Audit**

**1. Statutory Audit:** any audit carried on as per the requirement of law is called as a statutory audit. eg: all companies have to get their accounts audited as per the provision of the company's Act of 1956.

**2. Non statutory Audit:** These are the audits not specially required by law. The scope of the audit will be outlined by the contract between the auditor and the clients.

**3. External Audit:** external audit is a critical review of the representation of the published financial statements. It is compulsory for all companies which are listed in the stock exchange.

**4. Internal Audit:** this is a review of operations which is carried out sometimes continuously by specially assigned staff within the client business.

**5. Periodical/ Annual Audit:** it is a kind of audit where the auditor verifies the accounts at the end of the financial year.

**6. Interim Audit:** It's an audit conducted in the middle of the accounting year before the accounts are closed.

**7. Partial Audit:** When an auditor is asked to audit only a part of the account system. Eg: he may be asked to audit only the payment side of the cash book.

**8. Cost Audit:** cost audit is defined as the verification of cost accounting records.

**9. Management Audit:** Management audit may be defined as a comprehensive examination of an organizational structure of a company, institution/government and its plans and objectives. It means the examination of operations and use of human and physical facilities. The main objective of "management audit" is to see how far the objectives of "management" are fulfilled.

### **Internal Audit**

Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization.

### **Advantages of Internal Audit**

The advantages of internal audit are as follows:

1. Staffs remain alert because their work shall be checked by the internal auditor. So, accounting remains correct.
2. Internal audit helps to detect errors and frauds and provides suggestions to improve them which help the management to take corrective action.
3. Internal audit detects the misuse of resources in time which helps to reduce unnecessary expenses.
4. Internal audit checks the efficiency of staffs which helps to increase the efficiency of them.
5. Internal audit checks the books of accounts, detects errors and frauds and helps in its correction which makes the act of final auditor easier. It is also helpful to show the reliable and accurate statement.
6. Internal audit increases the morale of honest staff because evaluation of performance of any staffs will be made at any time.

### **Disadvantages of Internal Audits**

1. Internal audit reports are not accepted by shareholders and therefore it is for only management use. The company has to conduct external audit irrespective of fact whether it has conduct internal audit or not, therefore it results in additional costs for the company for hiring internal auditors.
2. The audit staff may give suggestion for proper working of business. The top- level management may not pay attention to the suggestions. In this way the audit work cannot help the business.
3. Internal audits are not full proof in the sense that it cannot eliminate or catch all the frauds and therefore some chances of frauds happening even after internal audit is done.

**What are the differences between Internal and External Auditors?**

<b>External Auditors</b>	<b>Internal Auditors</b>
1. Independent of the organization	1. Responsible to management, directors, and board of directors
2. Responsibilities are fixed by statute.	2. Responsibilities are specified by management.
3. Report to shareholders	3. Report to director or audit committee.
4. Perform work to enable them express an opinion on the truth and fairness of the accounts.	4. Work may range over many operational and financial areas and activities, as determined by management.

**Differences between Auditing and Accounting**

<b>Accounting</b>	<b>Auditing</b>
Is keeping records of the financial transactions and preparing financial statements.	Is critical examination of the financial statements to give an opinion on their fairness
Concentrates on the current financial transactions and activities	Concentrates on the past financial statements
An accountant is a employee of the company	An auditor is an independent professional
An accountant gets regular salary for his work	He gets remuneration for his professional work. Audit fees.
Accountant is not usually prosecuted for professional misconduct	Auditor can be prosecuted for professional misconduct
Report Submission to the management	Report Submission to the shareholders

### **How to Audit Balance Sheet**

Balance sheet audit: It's a kind of partial audit and is concerned with the verification of only those items appearing in the Balance Sheet. It is more popular in the USA.

For auditing balance sheet, the auditors have to check and verify the different assets and liabilities. Following are the main steps of balance sheet audit:

#### **1- Audit of current assets:**

First of all, the auditors have to audit current assets and see whether these are correct or not.

##### **a) Cash and Bank Balance Audit:**

In this case, the auditors have to check cash balance with its physical existence. For checking bank balance, he/she has to take the help of bank statement. If there is any difference between cash book and bank statement balance, he/she should check bank reconciliation statement of the company to know the real reasons behind this. If there is any error in it, he/she should note which will be the part of audit report.

##### **b) Account Receivable Audit:**

The auditors should also check account receivables. He/she has to see bad debts account and provision for doubtful debt account and its accounting treatment in balance sheet.

#### **2- Fixed Assets Audit:**

In this case, the auditors must check the depreciation on each asset. Asset's sale value and its profit or loss and balance value which has been shown in balance sheet.

#### **3- Investment Audit:**

In investment audit, the auditors should audit the source of these investments and he/she also should check different investment schemes.

#### **4- Audit of Liabilities:**

Auditors should check the solvency ability of company by liabilities audit. He/she should also audit account payable, bank loans, outstanding liabilities. His/her eyes should look the total payment to creditors and what is recorded in the books. If he examines the difference between both, it may be mistake or fraud and it should be noted. He/she also examines any misconduct of accounting department relating to paying liabilities.