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IFTM University, Moradabad, Uttar Pradesh

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AUDITING: AN INTRODUCTION

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CHAPTER – 1

AUDITING

AN INTRODUCTORY CONCEPT

1.2 INTRODUCTION -AN OVERVIEW OF AUDITING:

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the barfly makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.3 ORIGIN AND EVOLUTION

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances.

The original objective of auditing was to detect and prevent errors and frauds Auditing evolved and grew rapidly after the industrial revolution in the 18th century With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.

The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.
In India the companies Act 1913 made audit of company accounts compulsory With the increase in the size of the companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts The companies Act.1913 also prescribed for the first time the qualification of auditors. The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the. accountants and auditors in the day to day work The later developments in auditing pertain to the use of computers in accounting and auditing.
In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

1.4 DEFINITION
The term auditing has been defined by different authorities.

1. Spicer and Pegler: "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors 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 that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

2. Prof. L.R.Dicksee. "auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate.

3 The book "an introduction to Indian Government accounts and audit" "issued by the Comptroller and Auditor General of India, defines audit “an instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor."

1.5 FEATURES OF AUDITING

a. Audit is a systematic and scientific examination of the books of accounts of a business;
b. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
c Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.
d. Audit is a critical review of the system of accounting and internal control.
e. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.
f. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.
g The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

1.6 OBJECTIVES OF AUDITING

There are two main objectives of auditing. The primary objective and the secondary or incidental objective.
a. **Primary objective –** as per Section 227 of the Companies Act 1956, the primary duty (objective) of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company’s state of affairs and the profit and loss A/c gives a correct figure of profit of loss for the financial year.
b. **Secondary objective –** it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objective of auditing are:
i. Detection and prevention of Frauds, and
ii. Detection and prevention of Errors.
Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated.
Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. Clerical errors.

1.7 EXPRESSION OF OPINION

When we speak of the objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exists as to distort what the accounts should really convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statement in such a way as to enable the reader of the accounting statement to form a correct view of the slate of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's Case* as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective; it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statement show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors of frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account. If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston Cotton Mills Co.*

1.8 DETECTION OF FRAUD & ERRORS

The term fraud means the willful misrepresentation made with an intention of deceiving others. It is a deliberate mistake committed in the accounts with a view to get personal gain. In accounting, fraud means two things.

a. Defalcation involving misappropriation of either cash or goods; and

b. Fraudulent manipulation of accounts not involving defalcation.

1.8.1. FRAUD COVERS THE FOLLOWING

1.8.2 FRAUD THROUGH DEFALCATION.

Following are the methods of defalcation involving misappropriation of cash or goods

1 By misappropriating the receipt by not recording the same in the cashbook.

2 By destroying the carbon copy or counter foil of the receipt and misappropriating the cash received.

3 By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book.

4 By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.

5 By omitting to record cash donations received by non-profit making charitable institutions.

6 By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.

7 By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.
8 By adopting the method of "teeming and lading" or "lapping process". Under this method cash received from one debtor is misappropriated and deficiency in that debtors account is made good when another payment is received from second debtor by crediting the second debtors account less by that amount. This process is carried out round the year.
9 By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.
10 By misappropriating the sale proceeds of VPP sales or sales of goods on approval basis by treating the transaction as goods received or not approved.
11 By under casting receipt side total of the cashbook.
12 By recording fictitious or bogus payments.
13 By recording more payments than actual amounts paid by altering the figures on the vouchers.
14 By showing the same payment twice.
15 By showing credit purchases as cash purchases and misappropriating the amount.
16 Recording personal expenses as business expenses.
17 By not recording discounts and allowances given by the creditors and misappropriating the amounts.
18 By overcasting the payment side total of the cashbook.
19 Recording fictitious and inflated purchases and misappropriating that amount.
20 By suppressing the credit notes for returns and showing the full payment to creditors.
21 By including the names of dummy workers or the workers who have?
The job in the wage sheets and misappropriating the amount.
22 By over casting the total of wages sheets and drawing that amount for misappropriation.
23 By misappropriating the undisbursed wages.

1.8.3 FRAUD THROUGH MANIPULATION OF ACCOUNTS

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Generally this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

1.8.4 THE AUDITOR CAN SUSPECT FRAUD UNDER THE FOLLOWING CIRCUMSTANCES.

1. When vouchers, invoices, cheques, contracts are missing etc.
2. When control account does not agree with subsidiary books.
3. When the difference in trial balance is difficult to locate.
4. When there are greater fluctuation in G.P. and N.P. ratios.
5. When there is difference between the balance and the confirmation of the balance by the parties.
6. When there is difference between the stock as per records and the stock physically counted.
7. When the explanation given by the client is not satisfactory.
8. When there is a overwriting of some figures.
9. When there is a contradiction in the explanation given by different parties.

1.8.5 PROCEDURE TO BE FOLLOWED TO DETECT ERRORS.

Following procedures may be adopted by the auditor to detect the errors.
1. Check the opening balances from the balance sheet of the last year.
2. Check the posting into respective ledger accounts
3. Check the total of the subsidiary books.
4. Verify all the castings and the carry forwards.
5. Ensure that the list of debtors and creditors tally with the ledger accounts.
6. Make sure that all accounts from the ledger are taken into accounts.

7. Verify the total of the trial balance.
8. Compare the various items from the trial balance with that of the previous year.
9. Find out the amount of difference and see whether an item of half or such amount is entered wrongly.
10. Check differences involving round figures as Rs. 1,000; Rs. 100 etc .
11. See where there is misplacement or transposition of figures that is 45 for 54; or 81 for 18 etc.
12. Ultimately careful scrutiny is the only remedy for detection of errors.
13. See that no entry of the original book has remained unposted.

1.8.6. THE AUDITOR SHOULD PERFORM THE FOLLOWING DUTIES IN RESPECT OF FRAUD.

1. Examine all aspects of the finance.
2. Vouch all the receipts from the counterfoils or carbon copies or cash memos, sales mart reports etc.
3. Check thoroughly the salary and wages register.
4. Verify the methods of valuation of stocks.
5. Check up stock register, goods inwards notes, goods out wards books and delivery challans etc
6. Calculate various ratios in order to detect fraudulent manipulation of accounts
7. Go through the details of unusual items.
8. Probe into the details of the problems when there is a suspicion.
9. Exercise reasonable skill and care while performing the duty.
10. Make surprise visit to check the accounts.

1.9 ADVANTAGES AND INHERENT LIMITATIONS OFAUDIT

1.9.1 ADVANTAGES OF AUDIT

Advantages of audit

A. Businessman's point of view	B. Investor's point of view	C. Other Advantages.
1 Detecfonof errorsandfrauds	1 . Protects interest	1. Evaluate financial status
2 Loan from ban	*2.* Moral check	*2.* Usting of shares
3 Builds reputation	3. Proper valuation of investments	3. Settlements of claims
4 Proper valuation of assets	4 Good security	4 Evidence in court
5. Government acceptance		5. Settlement of accounts
6. Update accounts		6. FaciStates calculation of Purchase Conskteraton.
7 Suggestions for improvement		7 Facilitates taxation
8. Useful for agency		

1.9.2 LIMITATIONS OF AUDITING

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expresses by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. Further, the process of auditing is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of an audit procedure. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the overall objectives of an audit. The inherent limitations are:

I. First of all, auditor's work involve exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

II. The entire audit process is generally dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to records transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal controls system also contribute to inherent limitations of an audit. Generally following are the Limitations of auditing

1. **Non-detection of errors/frauds:-** Auditor may not be able to detect certain frauds which are committed with malafide intentions.
2. **Dependence on explanation by others:-** Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.
3. Dependence on opinions of others:- Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc. he can not be an expert in all the fields
4. **Conflict with others:** - Auditor may have differences of opinion with the accountants, anagement, engineers etc. In such a case personal judgement plays an important role. It differs from person to person.
5. **Effect of inflation :** - Financial statements may not disclose true picture even after audit due to inflationary trends.
6. **Corrupt practices to influence the auditors** :- The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.
7. **No assurance** :- Auditor cannot give any assurance about future profitability and prospects of the company.
8. **Inherent limitations of the financial statements :-** Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts can not be measured. Audited statements due to these limitations can not exhibit true position.
9. **Detailed checking not possible :-** Auditor cannot check each and every transaction. He may be required to do test checking.

1.10.3 TRUE AND FAIR VIEW.

An audit of accounts by an independent expert assures the outside users that the accounts are proper and reliable. The outsiders can rely on the accounts if the auditor reports that the accounts are true and fair. The accounts are said to be true and fair:

1. When the profit and loss shown in the profit and loss account is true and fair, and
2. Also when the value of assets and liabilities shown in the balance sheet is true and fair.

What constitutes true and fair is not defined under any law. However the following general guidelines may be laid down in connection with true and fair.

a) **Conform to accounting principles:** The books of accounts must be kept according to the normally accepted accounting principles such as the concept of entity, continuity, periodical matching of costs and revenue, accrual and double entry system etc.
b) **No window dressing or secret reserves:** The accounts must show the financial position and the profit or loss as they are. I.e. there is neither an overstatement nor an understatement. There

should be in other words neither window dressing nor secret reserves. In window dressing the accounts are made in such a way as to show a much better condition than the actual condition. The profit and the net worth are overstated The accounts are said to show true and fair view when the accounts show only the actual conditions as it is. i.e. the profit and the net worth are shown as they are.

In order to show a true and fair view the auditor should ensure that:

1. The final accounts agree with the books of accounts.
2. The provision for depreciation is proper.
3. The closing stock is physically verified and valued properly.
4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.
5. Proper provision is made for bad and doubtful debts.
6. Capital expenses is not treated as revenue expenses and vice versa.
7. Capital receipts are not treated as revenue receipts.
8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.
9. Contingent liabilities are not treated as actual liabilities and vice versa.
10. Provision is made for all known losses and liabilities
11. A reserve is not shown as a provision and vice versa
12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.
13. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income are recorded properly.
14. Expected or anticipated gains are not credited to the profit and loss account.
15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly
16. The exceptional or non-recurring transactions are disclosed separately in the accounts.

3. Disclose all material facts: The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities. Material means important and essential. The disclosure of important matters in the accounts helps the users in taking business decisions. There should be neither suppression of vital facts nor mis-statements.

4. Legal requirements: In case of limited company the account must disclose the matters required to be disclosed under the Companies Act. The final accounts must be in the format prescribed under Schedule VI of the Companies Act, 1956. Special companies such as banks, insurance, electricity supply companies prepare accounts as prescribed under special laws. A co-operative society, a trust etc. must also prepare the accounts as required under relevant laws.

5. Requirements of Institute of Chartered Accountants of India: The accounts must also be in accordance with the various guidelines prescribed by the ICAI. These guidelines are contained in the statements, standard and guidance notes issued by the institute from time to time.

1.10.4 ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Apart from this abvious utility, there are other advantage of audit. Some or all of these are of considerable value even to those enterprises and organization where audit is not compulsory, these advantages are given below:

(a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(b) It acts as a moral check on the employees from committing defalcations or embezzlement.

(c) Audited statements of account are helpful in setting liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(d) This are also use for settling trade disputes or higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastage and losses to show the different ways by which these might be checked, especially those that occur due to the absence of inadequacy of

internal checks or internal control measures.
(f) Audit ascertains whether the necessary books of accounts and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respects.
(g) As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weakness, inadequacy, etc., in them.
(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.
(i) Government may require audited and certificated statement before it gives assistance or issues a licence for a particular trade.

1.10.5 QUALITIES OF AN AUDITOR

So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles. He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important.
Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable. He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.
The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. AAS-8 on ‘Audit Planning’ emphasises that an auditor should have adequate knowledge of the client’s business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.
He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.
Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it. Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities.
He said, “an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true”.

1.13 LET US SUM UP

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period. The term auditing has been distinguished

from accounting and investigation The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation.
Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like.
Objectives of audit are broadly classified into
a) primary objective and
b) secondary objective.
Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds. A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc. Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit.
Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

1.14 KEYWORDS

Auditing: Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.
Continuous audit: An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.
Errors: Mistakes committed innocently and unknowingly while making entries in the books of accounts.
Frauds: Fictitious entries made in the books of accounts with certain motives.
Interim audit: An audit which is conducted for a part of the accounting period for some specific purpose.
Investigation: Examination of accounts for special purpose.
Qualified auditor: A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act,1949.
Statutory audit: An audit undertaken under any specific statute or Act.
True and fair view: A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain
errors and fraud.

1.16 QUESTIONS

1. Check your progress

i) Define auditing.
ii) Distinguish between accountancy and auditing.
iii) State whether the following statements are true or false.
a) Auditing of accounts is compulsory in a partnership firm.
b) Auditing of accounts is undertaken to detect fraud in the books of accounts.
c) A professional auditor cannot take up the work of preparing the accounts of a company.
d) Investigation is taken up only on behalf of the owner of the entity.
e) Investigation of accounts is not compulsory but audited by the qualified professional accountant.

f) In ancient period the audit was confined to cash audit and not to locate fraud.
g) Audit of company accounts is compulsory under the Chartered Accountants Act, 1949.

2. Check your progress

1. List the types of clerical errors.
2. Distinguish between errors and fraud.
3. What do you mean by window dressing.
4. Fill in the blanks with the appropriate word given in the bracket:

a) when two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as ______(error of omission/compensating error)
b) ———————are always committed deliberately and intentionally to defraud the proprietors of the organization (error/fraud)
c) the main objective of ———————is to avoid or reduce the tax liability.(window dressing/secret reserves)
d) to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is—————of an audit .(primary objective/secondary objective)

5 State whether the following statements are true or false.

a) The main object of auditing is to detect frauds from the books of accounts.
b) The allocation of amount between capital and revenue expenditure is a compensating error.
c) Audited accounts are free from errors and fraud.
d) The main purpose of auditing is to report on the efectiveness of the internal check system of organisation.
e) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.
f) The auditor is appointed to report on the financial position of the company carrying out an analytical examination of the books of accounts related documents and internal and external evidences.
g) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.

CHAPTER- 2

2.1 MEANING AND DEFINITION OF ERRORS AND FRAUDS

DEFINITIONS :

Error refers to unintentional mis-statements or misdescriptions in the records or books of accounts by the books keepers. In other words, they are unintentional mistakes arising on account of negligence or ignorance. Errors may be basically of two types :

(a) Principal Errors and (b) Clerical Errors

(a) principal Errors : these errors arise generally when the principals of accountancy are not observed while recording a transaction. For instance a capital expenditure is recorded as a revenue expenditure or vice versa. Such errors are difficult to detect as the Trial Balance tallies inspite of such errors. Basically it arises on account of ignorance of accounting principles. Following are the examples of principles errors :

(1) Wages paid for installation of plant and machinery is recorded as wages paid to workers
(2) Revenue receipt is recorded as a capital receipt
(3) Incorrect provisions for doubtful debts
(4) Incorrect provisions for discount on debtors

(5) Rent paid to landlord debited to the landlord account instead of rent ac account
(6) Overvaluation or undervaluation of stock on account of ignorance

(b) Clerical Errors – these errors arise on account of negligence of the accounting staff. They are called technical errors clerical errors may be further divided as errors of omission, Errors of Commission, Duplicating Errors and Compensating Errors.

2.2 REASONS AND CIRCUMSTANCES

R.K. Mautz, has classifieds the reasons and circumstances of errors and he has include fraud in the broad category of errors. The classifications are the following.
1. ignorance on the part of employees of accounting development, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortage of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever presents desires to hold taxes on income to minimum.
A sixth cause may be added to those Mr.Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in positions of authority to :
I. Show up the picture depicted by the statements;
II. Depress the picture depicted by the statements; and
III. Convert the error to a personal benefit.

2.4.2 Misappropriation of Cash
Misappropriation of cash is also called embezzlement of cash. It means fraudulent appropriation of cash belonging to another person by one who has been entrusted to it. Misappropriation may take place in the following ways:
1) Not recording full cash sales and pocketing a part of the proceeds
2) Teeming and Lading
3) Misappropriation the money received from sale of goods sent on sale or return basis
4) Making fictitious entries in customer's accounts for bad debts, discount etc.
5) Misappropriation the amount received from sale of defective goods by not recording such sale
6) Recording fictitious cash purchase
7) Recording payments to fictitious creditors
8) Not recording discounts received from creditors
9) Recording payments to dummy or ghost workers and pocketing the money, etc.
2.4.3 Misappropriation of Goods
It refers to fraudulent application of goods by those who handle them. It can be done by recording sales of larger quantities and misappropriating the balance or by recording purchase of large quantities receiving less quantity and then receiving the balance amount privately.
2.5 RISK OF FRAUD AND ERROR IN AUDIT
The following events may increase the risk of fraud or error -
1. Internal Control Faults: Weaknesses in the design of internal control system and non-compliance with laid down control procedures, e.g. a single person being responsible for receipt of all pasts/ mails and marking it ti the relevant secions or two persons responsible for receipt of all posts/ mails but the same is not followed in the practice.
2. Doubts about the integrity or competence of the management,

e.g. domination by one person, high rate of employee turnover, frequent change of legal counselsof Auditors, significant and prolonged understaffing of the accounts department, etc.
3. Unusual pressures within the entity, e.g. industry is doing well but the Company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support the share market price, etc.
4. Unusual transactions e.g. transactions with related parties, excessive payment for certain services to lawyers, etc.
5. Problems in obtaining sufficient and appropriate audit evidence,
E.g. inadequate documentation significant differences between the figures as per accounting records and confirmation received from third parties. Etc.

2.6 AUDITOR'S DUTIES AND RESPONSIBILITIES IN RESPECT OF FRAUD

The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error. An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statement resulting from fraud or error does not, in and of itself, indicates:
a) Failure to obtain reasonable assurance,
b) Inadequate planning, performance or judgment,
c) Absence of professional competence and due care, or,
d) Failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management. Those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's reports based on the result of these procedures. In planning and performing his examination the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error. Which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a significant fraud, the same should be disclosed in the financial statement. If adequate is not made, there should be a suitable disclosure in his audit report.

2.7 BASIC PRINCIPLES OF AUDIT

AAS-1 describes the basic principles, which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. These are:-

1. Integrity, objectivity and independence:
The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever it's actual effect, as being incompatible with integrity and objectivity.
2. Confidentiality:
The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is legal or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.
3. Skill and competence:
The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognized for this purpose and practical experience under proper supervision.
4. Work performed by others:
When the auditor delegates work to assistant* or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise & review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.
5. Documentation:
The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.
6. Planning:
The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.
7. Audit evidence:
The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.
8. Accounting system & internal control:
The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.
9. Audit conclusions and reporting:
The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.
The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.
2.8 AUDIT TYPES
MEANING:
Audit is not legally obligatory for all types of business organizations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.
(i) Audit required under law : The organizations which require audit under law are the following:
(a) companies governed by the Companies Act, 1956;
(b) banking companies governed by the Banking Regulation Act, 1949;
(c) electricity supply companies governed by the Electricity supply Act, 1948;

(d) co-operative societies registered under the co-operative Societies Act, 1912;
(e) public and charitable trusts registered under various Religious and Endowment Acts;
(f) corporations set up under an Act of parliament or State Legislature such as the Life Insurance Corporation of India.
(g) Specified entities under various sections of the Income-tax Act, 1961.
(ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. in respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purpose like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special feature which will be seen later.

INTERIM AUDIT:

An audit that is taken up between two annual audits is called an Interim Audit. A specific date, as per the client's requirement is taken into account, e.g. 30th September, 31st December, etc. a trial balance is drawn and verified with a view to prepare financial statement. Financial statement are prepared and authenticated for the interim audit period. Assets and liabilities are verified for interim balance sheet purposes. Independence is considered less independent than the statutory Auditor; generally an employee of the enterprise will be the internal auditor. In the interim audit no format is prescribed. It depends on the nature of work, coverage and audit observations.

CONTINUOUS AUDIT:

A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period. A continuous audit is preferred for the following reasons:

i. It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors of frauds uncovered by such an audit.
ii. The frequent attendance by the staff deters persons so inclined, from committing a fraud.
iii. The accounting staff of the client is motivated to keep the books of account up-to-day.

2.9 ACCOUNTING CONCEPT RELEVANT TO AUDITING

INTRODUCTION

1. The purpose of this standard is to establish standards on the concept of materiality and its relationship with audit risk.
2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

2.9.1 MATERIALITY:

1. Information is material if its misstatement (i.e., omission or erroneous Statement) could influence the economic decisions of users taken on the Basis of the financial information. Materiality depends on the size and Nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.
2. The objective of an audit of financial information prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is materiality of professional judgment.
3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity at both the overall financial information level and in relation to individual account balances and classes of transactions.

Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial

information, and consideration relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.
4. Although the auditor ordinary establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misted by the description.
5. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedures could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.
6. Materiality should be considered by the auditor when-
(a) Determining the nature, timing and extent of audit procedures;
(b) Evaluating the effect of misstatements.

2.9.2 GOING CONCERN:

1. The purpose of this Auditing and Assurance standard (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the financial statements.
2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.
3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.
4. An entity's continuous as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary.

Accordingly, asset and liabilities are recorded on the normal course of business. If this assumption is unjustified, the entity may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statement may need to be adjusted.

APPROPRIATENESS OF THE GOING CONCERN ASSUMPTION

I. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
II. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

I am extremely cheerful to see the nature of this article. You rock for safeguarding immense stuff and read more to manage all types of work and projects.Keep it up..

REPLY

GargGoyal *25 March 2022 at 04:23*

Thanks for sharing this information
Chartered Accountant firm
Accounting Outsourcing Companies in India
Tax Consultant in India
Starting Business in India
Foreign investment approvals in India
indirect taxation firm in India
Direct tax consultancy in India
Registration of foreign companies

REPLY

sanjay *28 March 2022 at 00:45*

Nice blog
Great Information.
The Asian Journal of Government Audit is a popular resource for the SAI community for promotion of sound and effective audit systems.
This bi-annual Journal has been in circulation since 1983 and has provided a forum to ASOSAI members for discussion and dissemination of good practices.
The Journal accepts articles, special reports, news items and other materials from member SAIs of ASOSAI.

REPLY

Instant Informer *17 June 2022 at 03:00*

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