

Chapter 1

AUDITING CONCEPT

1.1 EVOLUTION

The word “audit” has been derived from the Latin word “audire” meaning “to hear”, “listen” or “give credence to”. In ancient days an Auditor used to listen to the accounts read out by the accountant in order to check them.

Auditing was used in all countries such as Mesopotamia, Egypt, Greece, Rome, U.K. and India. The Egyptians, the Greek and the Romans used to get their public accounts audited. Audit of accounts of private house was rare. Even in India Auditing from the times of Vedas, Ramayana, and Mahabharata. Basically accounting and auditing had their origin in the need for the government to control the income and expenditure of the state and the army.

The industrial revolution in the 18th century and also advent of joint stock companies increased the number and complexity of business transactions. In these companies management and ownership was different. The director manages these companies but the real owners were the shareholders. This gave stimulus to the development of auditing process.

Due to increase in the number of companies, companies act made it compulsory to audit the book of accounts and give report to the real owner i.e. shareholders. In India, companies act 1913 made it compulsory of audit of accounts. After independence the companies act 1956 enlarge the scope of auditors work and a power transferred to the Institute of Chartered Accountants of India through Chartered Accountants 1949. Presently only a practicing Chartered Accountant can act company auditor.

1.2 DEFINITIONS

Different experts and association have defined Auditing varyingly. Let us discuss and understand some of the important definitions:

The International Auditing Practices Committee defines Auditing as “The independent examination of financial information of any entity,

whether profit oriented or not and irrespective of its size, or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

Auditing and Assurance Standard (AAS1) by ICAI: “Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expression an opinion thereon”

According to Ronald Irish: “Auditing in its modern concept, is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the balance sheet and the net income revealed by the profit and loss account.”

1.3 OBJECTIVE OF AUDITING

“The main object of an audit is to ascertain that the Balance Sheet and Profit & Loss Account of an undertaking is showing true and fair view of its financial positions and earnings.” However objectives of audit can be divided into two different parts:

1. Primary objectives
2. Secondary objectives

1.3.1 Primary Objectives / Basic Objectives

The main or primary objective of Auditing is to find out the reliability and validity of the financial statements so as to render opinion on the truthfulness and fairness of the presentations in those statements. The auditor has to give an opinion on financial statements whether they are True and Fair view i.e. whether a) Balance sheet shows true and fair view of the concern, b)the profit and loss accounts give a true and fair view of the profit or loss of the concern, c)all the material facts has been disclosed, d) the organization has followed all the compliance with regarding to legal requirement and e) Final accounts are made according to the recognized accounting principles and auditing standards laid down by professional bodies, like ICAI.

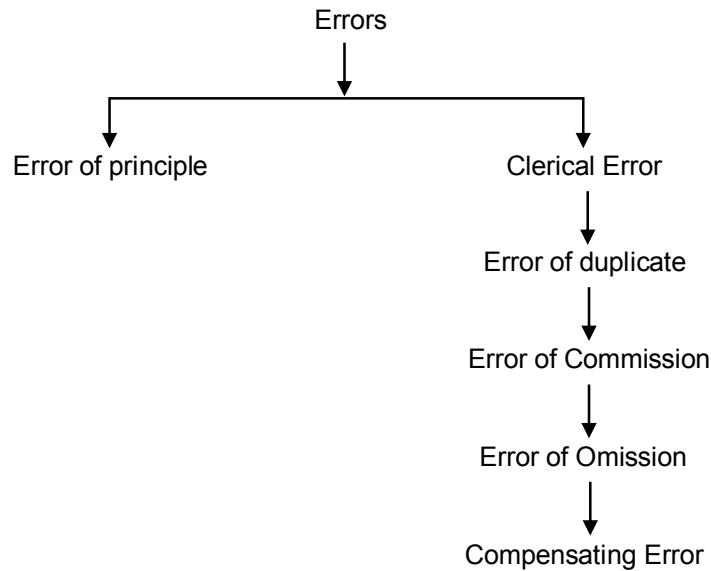
1.3.2. Secondary Objectives / Incidental Objectives

The secondary objective of audit is to detect and prevent the errors and frauds. An error is generally taken to be innocent and not deliberate. Where it appears to be willfully made, it assumes the character of a fraud.

The term “fraud” refers to an intentional act by one or more individuals of management, employees or outsiders, severally or jointly, involving the use of deception to obtain an unjust or illegal advantage.

It’s not an objective of an audit to give a guarantee that all is well with the concern. A clean audit report does not imply that the management has efficient.

1.4 ERRORS AND FRAUDS



The accounting errors based on their nature can be of the following types:

1. Clerical Errors
2. Errors of Principle

1. Clerical Errors: The errors which are committed by accounting clerks are called clerical errors. These errors are committed in the process of recording financial transactions. These take place due to the carelessness of the clerk responsible for recording financial transactions. Clerical errors are also called technical errors. The principal types of clerical errors are as follows:

- (a) **Errors of Omission:** The errors committed by not recording a transaction either in the book of original entry or in the ledger book are errors of omission. Such an omission may be either complete or partial.

Complete Omission: Complete omission takes place if a transaction is not recorded in the journal at all. For example, goods sold to Mr. A for ₹ 10,000 were not recorded in the sales book at all. A complete omission of transaction may occur due to many reasons such as sales invoice misplaced or lost.

Partial Omission: Partial omission occurs if a financial transaction is recorded only partially. For example, partial error of omission occurs if goods sold to Mr. A for ₹ 4,000 is recorded in sales book but failed to be posted in John's account.

- (b) **Errors of Commission:** The errors which are committed while recording or posting a transaction are called errors of commission. Errors of commission may take place either in the journal or in the subsidiary books, or in the ledger. Such errors include posting wrong amounts, posting on wrong side of accounts, wrong totaling or carrying forward, and wrong balancing. For example, if purchase of goods for ₹ 10,000 is entered as ₹ 1,000 in the journal or in the ledger, such error is called errors of commission.
- (c) **Compensating Errors:** compensating errors refer to two or more errors which mutually compensate the effects of one another. If one error balances the effect of another error, then the two error are called compensating errors. For example, goods sold for ₹ 5,000, but wrongly posted to the customer's account as ₹ 500. Similarly, goods purchased for ₹ 5,000, but by chance, wrongly posted to the supplier's account as ₹ 500. The errors in the personal account are compensated by each other, as ₹ 4,500 short on the debit side of the customer's account and on the credit side of the supplier's account.
- (d) **Errors of Duplication:** Errors of duplication are those errors which arise because of double recording. Double posting of a transaction from journal or subsidiary books to ledger also create such errors. For example, goods sold to Mr. A, but this transaction is wrongly entered twice or more in the sales book or wrongly posted twice or more in John's account then it is called the errors of duplication.

2. Errors of Principle: Errors of principle are those errors which occur by violating the principles of accounting. Errors of principle may occur due to wrong allocation between capital and revenue expenditure, or wrong valuation of assets. For example, debiting the wage account instead of machinery account for the wage paid to the mechanics used

for the installation of machine and debiting the customer's account instead of cash account for the cash sales made. Errors of principle may also occur due to wrong valuation of assets by higher level staff.

1.4.1. Procedure to Detect Errors

Following procedure the auditor should follow to detect errors:

1. First start with the checking of the opening balance with the last year audited balance sheet.
2. After checking of opening balance start verifying the journal entry and then checking of posting into respective ledger accounts.
3. Than verify the subsidiary books.
4. Verify all the casting and carry forwards.
5. After that verify trial balance.
6. Compare the current year trial balance with the last year trial balance.
7. Calculate the total of both the side of trial balance if difference found than divided the difference amount with 2 figure which you arrive start find the amount in the ledger. Take for example difference in the trial balance is ₹ 20,000 than divide the amount with 2 so amount you arrived is ₹ 10,000 start finding ₹ 10,000 in the ledger.

1.5 FRAUDS

Fraud means intentional misrepresentation of financial information by management, employee or third parties.

Fraud may be of following types:

1. Fraud through defalcation
 - (a) Misappropriation of cash
 - (b) Misappropriation of goods
2. Fraud through accounts
 - (a) Not recording a transaction
 - (b) Recording the dummy transaction

1. Fraud through Defalcation

Following are the method of defalcation involving misappropriation of cash or goods:

A. Misappropriation of Cash:

- (a) Misappropriation of cash receipt by not recording the same,
- (b) By suppressing the cash either not recording the cash or showing them as credit sales,
- (c) Showing payment twice in the cash book
- (d) By teeming and lading procedure that is cash received from one debtor is appropriated and deficiency in that accounts of debtors is made good when cash received from second debtors and the deficiency in the second debtors is made good when cash received from third debtors and so on...

B. Misappropriation of Goods:

- (a) Goods may be misappropriated by showing dummy sales,
- (b) Goods are actually received in the organization but are shown as not received and good are misappropriated.

2. Fraud through Accounts

- **Not Recording a Transaction:** These types of errors are intentional like sales take place but not shown in the books of accounts.
- **Recording Dummy Transaction:** examples of these types of errors are showing wages or salary in the dummy workers accounts.

1.5.1 Circumstances Indicating Errors and Fraud

The circumstance indicates that there may exist errors or fraud:

1. Management is in the hand of single person,
2. Internal control in the organization in either weak or does not exist at all,
3. Turnover of the accounting staff is very high,
4. Professionals in the organization like lawyers or auditors are changes very frequently,
5. Depending on the few product or few customers,
6. Working capital in the organization is inadequate,

7. In the need of issue of share financial picture is to be shown in the better position,
8. Investment in the product line which is subject to rapid obsolescences,
9. There are many transaction with associates, related parties etc.,
10. Organization is making excessive payment for services,
11. Vouchers which are available for audit is not duly authorized or supporting document for the same is not available.

1.5.2 Auditors Responsibility for Errors and Fraud

ICAI has spelt out the responsibility of an audit for errors and fraud in ASS 4.

1. **Basic Responsibility of Management:** It's basically responsibility of the management to detect and prevent fraud in the book of accounts. It is for the management to prevent and detect fraud and errors in the system.
2. **Incidental Objective:** Basic objective of the audit is to state whether accounts are true and fair but with the basic objective the auditor incidental objective is to state that accounts are free from fraud and errors. While doing the audit the auditor should not only audit keep in mind books are true and fair but also free from major errors and fraud.

Basic idea behind is that auditor has taken a reasonable care for detecting errors and fraud. Though he is not responsible for errors and fraud but he should not fail in his duty to find out errors and fraud.

If during the audit auditor come to see that there exist errors and fraud in the book than he should take a reasonable step to rectify it. If there is error auditor should rectify it and confirm it. If there is fraud than if material he should state in the audit report.

1.6 ADVANTAGE OF AUDIT

The advantages of Audit are as follow:

1. **True and Fair Balance Sheet:** Once the Balance sheet are audited user of balance sheet are sure that assets and liabilities shown in the audited balance sheet show the true financial position of the concern.
2. **True and Fair Profit and Loss Account:** The user of the profit and loss account is assured that profit or loss in the profit and loss account is true and fair.

3. **As per the Legal Requirements:** audited Balance sheet means all the law applicable to the concern have been complied.
4. **Disclose all the Material Fact:** The audited financial accounts disclose all the material fact which is required by the investor for investment purpose.
5. **As per Standards of Accounting and Auditing Practice:** The ICAI has issued some standards of auditing and accounting, audited financial statement means all the standards are properly followed. This make audited balance sheet more reliable.
6. **Moral Check on the Employees:** Audit method or technique which auditors follow keeps the moral check on the employee. Any Errors found during the audit are removed this way keep the check on the employee.
7. **Tally with the Books of Accounts:** Audited financial statement means that it tallies with the books of accounts. Any users of financial statement need not look whole books of accounts but only see audited balance sheet.
8. **Detection of Errors and Fraud:** Audited financial statement means that financial statements are free from fraud and errors. Whenever any fraud or errors arise during the time of audited are rectified. Auditors can also take the advice of expert or management to rectify the errors.
9. **Facilitates Taxation:** Tax authorities rely on the audit financial for tax purpose.
10. **Loans from Bank or any Investors:** Any companies who want raise the loan through bank or any financial institution first step is to get the accounts audited.

1.7 INHERENT LIMITATION OF AUDITING

1. **Test Check:** Due to test check all the transaction are not checked because of this many errors and fraud are not detected.
2. **An Auditor has to Depend on the Expert:** in many circumstances auditors has to depend on the experts like lawyers, valuers, engineers. Circumstances may be like estimation of contingent liabilities, valuation of fixed assets etc...
3. **No Future Assurance:** audit is basically concern with past it never predict anything on future or never give any assurance on efficiency of the management.

4. **Postmortem of Accounts:** Auditing begins where accounting ends. The job of an auditor starts where an accountant finishes his task of preparation of accounts. Naturally, the auditor has to rely on different information and explanations given to him by the Accountant. In the process many times, misstatement of facts remain undiscovered even after the accounts have been audited.
5. **Inherent Limitations of Internal Control System:** An auditor before expressing his opinion mostly relies on the internal control system of the enterprise. Internal control is the overall control environment established by Management of an enterprise for effective and efficient monitoring and control of its operation. Internal control goes beyond the accounting functions of the organization and incorporates both accounting and administrative controls.

1.8 PRINCIPLES OF AUDIT (ASS 1)

The concept of separation of management from ownership fuelled the growth of this profession. The owners who could not participate in the day-to-day management of the enterprise wanted an assurance that the financial information prepared by the management is reliable. An audit provides such an assurance and enhances the credibility of the information. The role of audit can be depicted as follows.

1. **Integrity, Objectivity and Independences:** Integrity implies an attitude of straightforwardness, honesty, sincerity, uprightness and reliability.
2. **Confidentiality:** Auditor should not disclose the information acquired in the course of audit to any one, unless there is a legal or professional duty to do so and Consented by the client.
3. **Skills and Competence:** Audit should be conducted by persons
 - Who possess due professional care,
 - Who are adequately trained
 - With experience and competence
4. **Planning:** Planning helps an auditor to conduct an audit in an effective, efficient and timely manner. Planning includes: Acquiring knowledge about the client's business, gaining an understanding of the accounting system and revision of plan as and when required.

5. **Work Performed by Others:** An auditor cannot do all the work by himself. The work is done either through his assistants or other professionals, but he continues to be responsible for forming and expressing an opinion on the financial statements. While delegating the work to others, he will be entitled to rely on the work performed by them, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.
6. **Audit Evidences:** An auditor should obtain sufficient (quantum) appropriate (relevance and reliable) audit evidence through the performance of compliance and substantive procedures.
7. **Documentation:** An auditor should document matters, which are important in providing evidence that the audit was conducted in accordance with the basic principles governing an audit. The auditor should maintain the documents for a reasonable period of time to meet the demands of his practice
8. **Audit Conclusions and Reporting:** Auditor draws conclusions on the basis of Review and assessment of the audit evidence obtained; and his knowledge of the business, to form his opinion on the financial statements.
9. **Assessing the Accounting System and Internal Control:** An auditor should assess the accounting system to ensure that the system is adequate to record all the accounting information.

1.9 QUALITY OF AUDITORS

To be successful, an auditor should possess certain desirable qualities, besides having his formal qualification. His qualification requires that he should be a qualified chartered accountant. Besides, he should possess the following qualities:

1. Tactfulness
2. Cautious approach
3. Firmness.
4. Good temperament
5. Integrity etc.

He should be tactful in doing the job of auditing. While doing auditing, he should be cautious. He should have integrity, and independence.

He should possess the knowledge of common business laws. Like mercantile law partnership act, sale of goods act etc.

He should possess a thorough knowledge of taxation provisions prevalent in the country.

An auditor is required to critically comment upon the financial statements. He should possess requisite expert in that field. He should occupy the position of an expert in that field. He should have thorough knowledge of all accounting principles and procedures. He should also know the ways and means in which the business is being conducted.

By possessing these qualities, he can become a successful and effective auditor.

1.10 EXERCISE

1. Multiple Choice Questions

- (a) Audit has been derived from the latin word _____.
- (i) Audire
 - (ii) Audie
 - (iii) Audi
 - (iv) Aude
- (b) Today who can act as an auditor of the company?
- (i) Chartered accountant
 - (ii) Accountant
 - (iii) Practicing Chartered accountant
 - (iv) 12th pass accountant
- (c) Objective of an audit of financial statement is to enable the auditor to express an opinion whether financial statement are prepared in accordance with the
- (i) Provision of income tax.
 - (ii) With an identified financial reporting framework.
 - (iii) System of double entry book keeping.
 - (iv) With accounting policies laid down by the management.
- (d) In India, companies act _____ made it compulsory of audit of accounts.
- (i) 1956
 - (ii) 1972
 - (iii) 1965
 - (iv) 1913
- (e) During the audit the opening balance will be verified with
- (i) Current year balance sheet.
 - (ii) Current year trial balance.
 - (iii) Last year balance sheet.
 - (iv) Last year ledger.

- (f) Fraud through account can be taken place through
- (i) Not recording a transaction.
 - (ii) Recording a dummy transaction.
 - (iii) None of the above.
 - (iv) All of the above.
- (g) The risk of fraud increase when:
- (i) The auditor remain the same.
 - (ii) Management is in the hand of single person.
 - (iii) Cash balance is very high.
 - (iv) Bank balances remain low.
- (h) Auditor can obtain the sufficient appropriate audit evidence through the performance of:
- (i) Vouching.
 - (ii) Compliance and substantive procedures.
 - (iii) Reading of ledger.
 - (iv) None of the above.
- (i) How many principles is there in AAS 1- Principle of audit.
- (i) 10
 - (ii) 9
 - (iii) 8
 - (iv) 5
- (j) Fraud through defalcation is:
- (i) Employee fraud.
 - (ii) Management fraud.
 - (iii) Both of the above.
 - (iv) None of the above.
- (k) Auditing standards and auditing guidelines are issued the _____ board.
- (i) Government
 - (ii) ICAI
 - (iii) ICWA
 - (iv) ICSI
- (l) The full form AAS is _____.
- (i) Auditing and accounting standards
 - (ii) Accounting and auditing statements
 - (iii) Auditing Assurance standard
 - (iv) Auditing and Assurance standard
- (m) Auditing commences after _____.
- (i) Investigation is carried out
 - (ii) Accounting work is over
 - (iii) The general meeting is over
 - (iv) None of the above

- (n) _____ is not an error of commission.
- (i) Mathematical error
 - (ii) Compensating error
 - (iii) Posting error
 - (iv) None of the above

[Ans: (a) - (i), (b) - (iii), (c) - (ii), (d) - (iv), (e) - (iii), (f) - (iv), (g) - (ii), (h) - (ii), (i) - (ii), (j) - (i), (k) - (ii), (l) - (iv), (m) - (ii), (n) - (ii)]

2. State whether True or False

- (a) Audit has been derived from the latin word audire.
- (b) Primary objective of audit to detect and prevent the errors and frauds.
- (c) The term “fraud” refers to an intentional act by one or more individuals of management, employees or outsiders, severally or jointly, involving the use of deception to obtain an unjust or illegal advantage.
- (d) In India, companies act 1956 made it compulsory of audit of accounts.
- (e) During the audit the opening balance will be verified with the help of last year balance sheet.
- (f) There are 10 principle listed in ASS1- Principles of audit.
- (g) The auditor should dispose of the documents to meet the demands of his practice.
- (h) Planning helps an auditor to conduct an audit in an effective, efficient and timely manner.
- (i) Auditor should disclose the information acquired in the course of audit to anyone.
- (j) Auditor should not possess the knowledge of common business laws. Like mercantile law partnership act, sale of goods act etc.
- (k) Auditor should act like a bloodhound and not a watch dog.
- (l) Auditing begins where the accounting starts.
- (m) Audit should be systematically planned.
- (n) Audited accounts are free from errors and fraud.
- (o) Auditor can take the help of valuer, branch auditor, lawyer etc.
- (p) The auditor has to give an opinion on financial statements whether they are True and Fair view.

[Ans: (a) - True, (b) - True, (c) - True, (d) - False, (e) - True, (f) - False, (g) - False, (h) - True, (i) - False, (j) - False, (k) - False, (l) - False, (m) - True, (n) - False, (o) - True, (p) - True]

3.A. Match the Column

Column A	Column B
1. Basis Principles listed in	(a) Intentional error
2. Fraud	(b) Systematic recording of transaction.
3. Manipulation of accounts	(c) ASS9
4. Book keeping	(d) Management fraud
	(e) Audit

[Ans: 1. - (c), 2. - (a), 3. - (d), 4. - (b)]

3.B. Match the Column

Column A	Column B
1. Accountant	(a) Disclose all material fact
2. True and fair view	(b) Objective of audit
3. Manipulation of accounts	(c) Compiles the accounts
4. Confidentiality	(d) Management responsibilities
5. An auditor	(e) Work performed by others
	(f) Should be an independent

[Ans: 1. - (c), 2. - (a), 3. - (d), 4. - (b), 5. - (f)]

4. Answer in One Sentences

1. What is error of omission?
2. What is error of commission?
3. Give one examples of error of commission?
4. Define audit?
5. What is the object of audit?
6. Explain one limitation of audit?
7. What is error of principal?
8. Give one examples of compensating errors?
9. What are different types of fraud?
10. Give one example of fraud?

5. Theory Question

1. Define audit and explain its objective in brief?
2. Explain and define the term audit?
3. Explain the term error and fraud?
(Oct 2003)
4. Explain the term errors and procedure to detect error?
(Oct 2010, April 2013)
5. What is fraud and types of fraud?
(April 2003, Oct 2003, April 2004, April 2009)
6. Explain circumstances indicating errors and fraud?
7. What is advantage of audit?
8. Explain the term audit and its limitation?
9. Explain the principal of audit (AAS- 1)?
(April 2000, Oct 2001, Oct 2004, April 2008, Oct 2010, Oct 2012)
10. Short note – compensating error?
(Oct 2001)
11. Explain some quality of auditor?
12. Explain principals of audit?
(April 2000, Oct 2000, Oct 2001, April 2006, Oct 2006, Oct 2008, Oct 2010, Oct 2011)
13. Explain the term “worked performed by other” in context to auditing principal?
14. Explain fraud through accounts?
15. Explain the concept of “true and fair view”?
(Oct 2004, April 2005, April 2006, April 2009)