1 CHAPTER

Nature, Objective and Scope of Audit

<table>
<tr><th colspan="3">1.1 - Meaning, Objectives and Scope of Audit</th></tr>
<tr><td rowspan="2">Meaning of Audit</td><td colspan="2">An Audit is 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.
This definition has the following implications:
(a) Audit is independent examination.
(b) Examination is of financial information when the objective is to express an opinion.
(c) Requirement of audit applies in case of every entity, whether profit oriented or not (Commercial entities or NGOs), whatever is the business size of entity (Small Size entity or large size entity), whatever is the legal form of the entity (proprietor, partnership or company).</td></tr>
<tr><td>Points to be ensured that F.S. not misled anybody</td><td>Auditor engaged to perform the task of performing audit need to ensure the following:
(a) Ledger balances agree with the entries made in the books of account.
(b) Sufficient and Appropriate evidences are available for entries made in books of account.
(c) All transactions are being recorded in books of account, i.e. there is no omission.
(d) Information contained in the financial statements is clear and unambiguous.
(e) Amounts shown in financial statements are properly classified, described and disclosures are made in conformity with applicable Accounting Standards.
(f) Financial statements reflect true and fair view of financial results and financial position</td></tr>
<tr><td>Objectives of Audit</td><td colspan="2">(a) The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.
(b) The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise.
(c) The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.</td></tr>
</table>

<table>
<tr><td></td><td colspan="3">(d) 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.</td></tr>
<tr><td>Objectives of Auditor</td><td colspan="3">Covered in SA 200</td></tr>
<tr><td rowspan="5">Scope of Audit</td><td colspan="3">The scope of audit is determined by the auditor having regard to following:
(a) Terms of the Audit Engagement
(b) Requirement of Relevant Statute.
(c) Pronouncements of the ICAI.
However, the terms of engagement cannot supersede the requirements of statute or pronouncements of ICAI.</td></tr>
<tr><td>Points to be considered in determining Scope of Audit</td><td colspan="2">1. Audit should cover the examination of all aspects of an entity relevant to financial statements.
2. Auditor should assess the sufficiency and appropriateness of the information contained in the accounting records and other source data. For this purpose, auditor should
(a) evaluate accounting systems and internal controls
(b) perform necessary tests, enquiries and other verification procedure of accounting transactions and account balances.
3. To determine whether the information is properly disclosed in the financial statements, audit may involve
(a) comparing the financial statements with the underlying records
(b) considering the judgements used by management in preparing the financial statements.
4. Auditor is not expected to perform duties which fall outside the scope of his competence.
5. Limitations, if any, on the scope of audit that impair the auditor’s ability to express an unmodified opinion should be set out in his report.</td></tr>
<tr><td rowspan="3">Aspects to be covered in Audit</td><td>Examination of Accounting System & Internal Control</td><td>◆ To ascertain whether it is appropriate for the business and helps in proper recording of all the transactions.
◆ To determine the Nature, Timing and Extent (NTE) of Audit Procedures to be performed.</td></tr>
<tr><td>Reviewing the system & procedures</td><td>◆ To find out whether they are adequate and comprehensive.</td></tr>
<tr><td>Vouching of the transactions</td><td>◆ To ensure authenticity and validity of transactions.
◆ To check the arithmetical accuracy of the books of account.</td></tr>
</table>

			◆ To ascertain proper distinction into capital and revenue items.
		Verification of Assets & Liabilities	◆ To ensure existence and valuation of the assets and liabilities appearing in the balance sheet.
		Statutory Compliances	◆ In case of entities governed by some law, rules or regulations, for example in case of audit of a company incorporated under Companies Act, 2013.
		Expression of Opinion	◆ On true and fair view of state of Affairs as reflected by Balance Sheet. ◆ On true and fair view of Financial Results as reflected by Statement of Profit and Loss. ◆ On true and fair view of Cash Flows as reflected by Cash Flow Statement.
		Reporting on Other matters	As required by the law governing the entity.

Important Questions

Q. No. 1: The person conducting the audit should take care to ensure that financial statements would not misled anybody. Describe briefly the points the auditor should ensure for.

Q. No. 2: The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

Or

State the objectives of Audit according to SA 200

Q. No. 3: List the points that merit consideration in regard to scope of audit.

Q. No. 4: State briefly six important aspects to be considered by an auditor while conducting an audit.

or

State the matters which the statutory auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall audit approach.

or

State the principal aspects to be covered in an audit concerning financial statement of account.

[Nov. 15 (5 Marks)]

Q. No. 5: The duties of the auditor are limited to verification of the arithmetical accuracy of the books of the account. Comment.

1.2 - Types of Audit	
Audit required under law	(*a*) Companies governed by the Companies Act, 2013; (*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 LIC of India. (*g*) Specified entities under various sections of the Income-tax Act, 1961.
Voluntary Audits	◆ Audits of the accounts of proprietary entities, partnership firms, HUF, etc. ◆ In respect of such entities, 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 purposes 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.

Important Questions

Q. No. 6: Discuss the types of audits required under law. [Nov. 11 (5 Marks)]

1.3 - Advantages of Audit of Financial Statements	
1. Protect the interest of fund providers	It safeguards the financial interests of persons who are not associated with the management of the organisation e.g. partners or shareholders.
2. Moral check on employees	It acts as a moral check on employees from committing defalcations or embezzlement.
3. Settlement of Taxes, etc.	Auditing statements of accounts are helpful in settling of taxes, negotiating loans and for determining the purchase consideration for a business.
4. Settlement of Trade Disputes	Audited statements are useful for settling trade disputes for higher wages or bonus.
5. Detection of Wastages	Audited statements also help in detection of wastages and losses and shows the different ways by which these might be checked especially those that occurred due to absence or inadequacy of internal checks or internal control measures.
6. Proper maintenance of books of account	Independent audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.
7. Appraisal of controls	As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies etc.
8. Admission/retirement of Partner	Audited accounts are of great help in the settlement of accounts at the time of admission or death of the partner.
9. Grant of License	Government may require audited and certified statements before it gives assistance or issues the license for a particular trade.

Important Questions

Q. No. 7: What is the importance of having the accounts audited by independent professional auditors? [May 01 (8 Marks)]

Or

What are the advantages of Independent audit? [May 12 (8 Marks)]

Or

Discuss the following: Advantages of Independent Auditor. [May 15 (5 Marks)]

1.4 - Inherent Limitations of Audit

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

1. **The Nature of Financial Reporting**	The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable FRF to the facts and circumstances of the entity. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.
2. **Nature of Audit Procedures**	There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example: ◆ Management & others do not provide complete information intentionally/ unintentionally. ◆ Audit procedures used to gather audit evidence may be ineffective against fraud detection. ◆ Audit is not an official investigation into alleged wrongdoings:
3. **Timeliness of Financial Reporting & the Balance between Benefit & Cost**	◆ User expectation that the auditor will form an opinion on the F.S. within a reasonable period of time and at a reasonable cost. ◆ It results into use of Test checking and putting most of efforts over the areas having risk of material misstatement with corresponding less efforts in other areas.
4. **Other Matters that affect the Limitations of an Audit**	In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include: (*a*) Fraud, particularly fraud involving senior management or collusion. (*b*) The existence and completeness of related party relationships and transactions. (*c*) The occurrence of non-compliance with laws and regulations. (*d*) Future events or conditions that may cause an entity to cease to continue as a going concern.

Important Questions

Q. No. 8: Discuss Limitations of audit. [May 11 (8 Marks)]

Or

"The process of auditing is such that it suffers from certain limitations". Discuss.

Or

ABC Ltd. requested the auditor to provide for absolute assurance in respect of its ten branches scattered in Mumbai and confirm that financial statements are free from material misstatements due to fraud or error. Advise.

Q. No. 9: DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the financial year 2017-2018. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor. Comment.

1.5 - Relationship of Auditing with other Disciplines	
Auditing and Accounting	◆ Accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. ◆ Auditing begins when accounting ends. ◆ It requires that the auditor must have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.
Auditing and Law	◆ Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into as per the requirements of law, in particular, when an entity is governed by any law, for example companies. ◆ It necessitates that an auditor should have a good knowledge of business and corporate laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. ◆ In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.
Auditing and Behavioural Science	The discipline of behavioural science is closely linked with the subject of auditing. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties, because of below mentioned aspects: ◆ While performing audit, auditor is required to interact with a lot of people in the organisation. ◆ Management auditor is expected to deal with human beings rather than financial figures. ◆ One of the basic elements in designing the internal control system is personnel. ◆ Internal control system in an organisation cannot work until and unless the people who are working in the organisation are competent and honest.
Auditing and Statistics & Mathematics	◆ While performing audit, auditor examines the transaction on test checking basis, wherein auditor is required to select the samples. ◆ Discipline of statistics plays an important role as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. ◆ The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.
Auditing and Data Processing	◆ Today, a number of organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. ◆ To carry out audit in an computerised environment, the auditor should have good knowledge of the components, general capability of the system and the related terms. ◆ In fact, EDP auditing in itself is developing as a discipline.
Auditing and Financial Management	◆ Auditing is closely related with functional fields of business such as finance, production, marketing, personnel and other general areas of business management. ◆ The auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. ◆ The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

AUDITING

B.com 3rd year

Meaning and concept: An audit is 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. This definition has the following implications:

(a) Audit is independent examination.

(b) examination is of financial information when the objective is to express an opinion.

(c) requirement of audit applies in case of every entity, whether profit oriented or not (commercial entities orpplies in case of every entity, whether profit oriented or not (commercial entities or NGOs), whatever is the business size of entity (Small Size entity or large size entity), whatever is the legal form of the entity.

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. 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. 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."

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.

Scope of Audit

The scope of audit is determined by the auditor having regard to following:

(a) Terms of the Audit Engagement

(b) requirement of relevant Statute.

(c) pronouncements of the icai. However, the terms of engagement cannot supersede the requirements of statute or pronouncements of ICAI.

Points to be considered in determining Scope of Audit

1. Audit should cover the examination of all aspects of an entity relevant to financial statements.

2. auditor should assess the sufficiency and appropriateness of the information contained in the accounting records and other source data.For this purpose, auditor should (a) evaluate accounting systems and internal controls (b) perform necessary tests, enquiries and other verification procedure of accounting transactions and account balances.

3. To determine whether the information is properly disclosed in the financial statements, audit may involve (a) comparing the financial statements with the underlying records (b) considering the judgements used by management in preparing the financial statements.

4. Auditor is not expected to perform duties which fall outside the scope of his competence.

5. Limitations, if any, on the scope of audit that impair the auditor's ability to express an unmodified opinion should be set out in his report.

Limitations of Audit

As per Sa 200 "Overall Objectives of the independent auditor and the conduct of an audit in accordance with Standards on auditing" the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. this is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. the inherent limitations of an audit arise from:

1. The Nature of Financial Reporting: from: 1. The Nature of Financial reporting the preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable FRF to the facts and circumstances of the entity. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application if additional auditing procedure.
2. Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
   *Management & others do not provide complete information intentionally/ unintentionally.
   * Audit procedures used to gather audit evidence may be ineffective against fraud detection.
   *Audit is not an official investigation into alleged wrongdoings.

3. Timeliness of Financial Reporting & the Balance between Benefit & Cost:

*User expectation that the auditor will form an opinion on the f.S. within a reasonable period of time and at a reasonable cost.
*It results into use of Test checking and putting most of efforts over the areas having risk of material misstatement with corresponding less efforts in other areas.

4. Other Matters that affect the Limitations of an Audit : In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

(a) Fraud, particularly fraud involving senior management or collusion.

(b) The existence and completeness of related party relationships and transactions.

(c) The occurrence of non-compliance with laws and regulations.

(d) Future events or conditions that may cause an entity to cease to continue as a going concern.

Relationship between Accounting and Auditing Principles

Accounting principles are general decision rules derived from the accounting concepts. It influences the development of accounting techniques which are specific rules to record specific transactions and events in an organisation. The end product of every accounting system is the financial statements containing financial information of an entity. In preparing and presenting the financial

statements it is essential to consider the following accounting principles :
1. Cost Principle
2. Revenue Principle
3. Matching Principle
4. Objectivity Principle (Verifiability Principle)
5. Consistency Principle
6. Full disclosure Priciple
7. Conservatism Principle
8. Materiality Principle
9. Uniformity and Comparability Principle.

As stated earlier an audit is the independent examination of financial statements of an entity, whether profit oriented or not, and irrespective of its size or legal form, with a view to express an opinion about the true and fairness of the financial information contained therein. An auditor while examining the financial statements have generally assured that all the fundamental accounting principles have been duly complied with in preparation and presentation of the same. So all these accounting principles are equally important to an auditor also and he must have adequate knowledge and clear understanding of it which will facilitate to discharge his professional liabilities properly. The accounting principles, compliance of which is verified in every audit process, may be considered as the basic foundation based on which financial statements are prepared ensuring its reliability, quality, acceptability and usefulness. So there exists a strong interrelationship between accounting and auditing principles. Moreover as per AAS 1 issued by ICAI on ''*Basic principles governing an audit*''

The following are the basic principles of auditing which govern the auditor's professional responsibility and should be complied with whenever an audit is carried out.
1. Integrity
2. Objectivity and independence
3. Confidentiality
4. Skills and competence
5. Planning
6. Documentation
7. Audit evidence
8. Accouting System and Internal Control
9. Work performed by others.
10. Audit conclusion and reporting.

Integrity: Integrity requires that the auditor should be straight forward, honest and sincere in his professional duty. Integrity is subjective and cannot be standarised by making law or by setting standards. While conducting an audit he should maintain an impartial attitude and appear to be free of any interest, so that society do not doubt his integrity.

Objectivity and independence: In the performance of any professional service, the auditor should maintain objectivity and independence. Objectivity means in reporting and working on any professional work he shall not be influenced by his personal whims and fancies or by other's directions. He should give his opinion based on facts, situation and as per generally accepted auditing principle. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him or to his own self-interest

Confidentiality: The auditor should maintain the confidentiality of information acquired in the course of his work. He should not disclose such information to a third party without specific permission of the client or unless there is a loyal requirement of professional duty to disclose.

Skills and competence:The audit must be performed and the report should be prepared with due professional care by persons who are having adequate training, experience, competence and have attained technical standards. The Institute of Chartered Accountants of India conducts continuing professional education for its members to keep them abreast of recent developments enhancing the quality of auditor.

Planning:The auditor should plan his work covering the following among other theories, which enables him to conduct an effective audit timely and efficiently.

- Acquiring the knowledge of client's business
- Acquiring the knowledge of client's accounting system, policies and internal control procedure
- Determining the degree of reliance of the internal control system and fixing up the extent of checking
- Formulating the audit programme

Documentation:The auditor should maintain systematically the documents created or collected for various matters during the course of audit. It is important as it provides evidence in future that the audit was carried out in accordance with the basic principles.

Audit Evidence: The auditor should obtain sufficient and appropriate audit evidence by compliance and substantive procedure which enable him to make perfect opinion on the financial statements. Compliance procedures are tests designed to have reasonable assurance that the internal control system depending on which the audit programme is formulated are in effect. Substantive procedures are tests of details of transactions, balance and include analysis of significant ratios and trends with a view to obtain evidence as regards completeness, accuracy and validity of the data produced by the accounting system.

Accounting system and internal control:Management is responsible for preparation of financial statements of an entity for which an adequate accounting system should be maintained involving various internal controls commensurate with the size and nature of the business. The auditor must ensure himself that internal control system is adequate providing assurance that all the accounting information which should be recorded has really been recorded. Extent of substantive procedure mainly depends on accounting system and internal control. It becomes less extensive if there is good accounting system and strong internal control system otherwise it will be more extensive.

Work performed by others:In the course of audit the auditor has to delegate work to assistants and also has to consider works performed by other auditors. In all such cases the auditors cannot escape the liability arising out of expression of opinion on the financial statements on the pretex that he delegated the work to others or used the work done by others. He, therefore, should carefully direct, supervise and review the work delegated to others and obtain reasonable assurance that works performed by other auditors and experts is adequate for his purpose.

Audit conclusion and reporting: The end product of every audit process is audit report through which auditor expresses his opinion about the financial statements of an entity. The auditor's conclusion and reporting should be based on the audit evidence obtained and generally includes as to whether :

(a) The financial statements are prepared on the basis of generally accepted accounting principles and the same is applied consistently.

(b) The financial information complies with relevant laws and regulations.

(c) There is adequate disclosure of all material facts. The audit report should contain a clear expression of opinion made on the financial information and it must be drawn in conformity with the requirements of the specific statute, agreement or regulation.

The audit report may contain following types of opinion : (i) unqualified or clean opinion (ii) qualified opinion (iii) adverse opinion (iv) Disclaimer of opinion In case of qualified, adverse and disclaimer opinion the audit report should state the reasons for forming such opinion

ERRORS AND FRAUDS

Errors*:* The term error refers to an unintentional mistake occurred in the financial statements, such as math or accounting mistakes in the accounting records and data related; oversight or misinterpretation of facts; misapplication of accounting policies.

Errors may be basically of two types : (a) Principal Errors and (b) Clerical Errors

(a) principal Errors and : 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

REASONS AND CIRCUMSTANCES OF ERROR AND FRAUD

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.

TYPES OF ERRORS

Commission: It includes posting errors, casting errors and totalling errors. For example ale to A has been recorded in B's A/c, it is a posting error or it is recorded in A's A/c but the amount is wrongly recorded. Similarly the balance of Rs.510 is carried forward as Rs.501, and then it is a casting error. Certain errors will not affect the trial balance for example posting in a wrong account will not affect the trial balance but if there is a totalling error or a casting error then the trial balance does not agree.

Omission: In the process of recording the accounting clerk may omit a transaction from recording either fully or partially. If a transaction is fully omitted, then it will be difficult to trace out, as both the debit and the credit are missing and the trial balance will tally inspite of these errors. However if a transaction is partly omitted, then only one aspect of the transaction is recorded. In this case it is easier to locate such an error.

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.

Frauds: 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.

TYPES OF FRAUDS

According to the standard Auditing practices issued by the Institute of Chartered Accountants of India, the term fraud refers to intentional misrepresentation of finance information by one or more individuals among management or third parties. In other words, it is intentional or wilful misrepresentation r deliberate concealed of a material fact with a view to deceive, cheat or mislead another person. Frauds may be of different types:
i) Manipulation of accounts, ii) Misappropriation of cash, iii) Misappropriation of Goods.

Manipulation of Accounts : Manipulation of accounts is said to be committed when a person makes a false entry in the books of accounts knowing it to be wrong, alters or destroys a true entry in the business records or prevents the making of a true entry in the business records. Normally it is done by people at the top management level. It is done to overstate or understate the profits and the financial conditions of the business so as to serve their purpose. Manipulation may be done in any of the following ways :

1) Non provisions of depreciation on fixed assets
2) Overvaluation or undervaluation of assets
3) Recording revenue expenditure as capital expenditure
4) Showing expenses of the next year in the current year's profit and loss account
5) Not recording currents year's accrued expenses etc. A comm0on form of manipulation of accounts is known as "window Dressing."

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.

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.

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.

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.

CLASSIFICATION OF AUDIT

Classification of audit may be done on various basis and on such classification different types of audit are noticed:

Objective wise: Internal and independent financial audit.

Periodicity wise: Periodical, Continuous, Interim, Final, Limited review

Organisation structure wise: Statutory, non-statutory

Specific matter wise: Cost, Management, Tax, Social propriety, performance etc

Periodical audit

Periodical audit means an audit which is done at the end of a specific period that the audit is commenced and completed in a single uninterrupted session with no chance of any collusion between audit staff and the clients staff and without any dislocation of clients work. Final audit is also known as periodical audit as it refers to a situation where the audit work is commenced only after the expiry of the period to be covered by the audit. Periodical audit is economical and very much convenient and useful for business houses which are small may be quarterly, half-yearly or yearly but only after periodic finalisation of accounts. In this case

Interim audit

An interim audit is that kind of audit which is conducted for a part of the accounting year with some interim purpose. It involves an audit of the financial statements or other data relating to only a part of the accounting year and is generally conducted between two periodical or regular audits. The purpose for which interim audit is conducted may be : (1) Declaration of interim dividend (2) Submission of accounts for a specific purpose as required by any authority. (3) For the disclosure of periodic financial information in compliance with any statutory requirements(4) For obtaining assurance as regards adquacy of internal control system in the organisation before starting its final audit.

Continuous Audit

According to Spicer and Pegler, ''a continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; Such audits are adopted where the work involved is considerable, and have many points in their favour, although they are subject to certain disadvantages.'' According to R.C. Williams ''a continuous audit is one where the auditor, or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends the clients offices at regular or irregular intervals during the period.''

Continuous audit is suitable in the following cases : (a) where final accounts are desired to be presented just after the close of the financial year, as in the case of a bank. (b) where the transactions are many in number and it is considered necessary to get them audited at regular intervals. (c) where the internal check system is not satisfactory. (d) where after every month or quarter the statement of accounts are prepared and required to be presented to the management. (e) where sales affected are very high