Unit I :- Auditing Introduction : *Dr. P.M. Herekar*

Unit I :- Auditing - Meaning, Objectives, Scope, general principles, Types of Audit, Internal & External Audit, Internal check

1. Meaning of Auditing:

The word audit has been derived from the Latin word *Audire* which means to hear. In olden days the expert independent person in accounting used to hear the explanation given by accountant to the queries raised by him and then used to report his opinion about the accuracy of accounting to the owners or managers of enterprise. These experts were called auditors.

Industrial revolution gave rise to corporate sector where the owners (i. e. shareholders do not participate in the day to day conduct of business. This resulted in the increase in the significance of the auditor and his report about the accounts showing true and fair view of business.

The term audit has been defined by some authorities as under:

Spicer and Pegler : "An Audit may, therefore, be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor 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 whether the Profit and Loss Account gives a true and fair view of the profit and loss for the financial period, according to the best of his information and the explanation given to him and as shown by the books, and if not, in what respects he is not satisfied."

In the opinion of **Taylor and Perry,** "An Audit is an investigation by an auditor into the evidence from which the final revenue accounts and balance sheet, or other statement of an organization have been prepared, in order to ascertain that they present a true and fair view of the summarized transactions for the period under review and of the financial state of the organization at the end date, so enabling the auditor to report thereon."

In simple words, an audit is a systematic and careful examination of books of accounts on the basis of vouchers, evidences, and other details. It is done by an independent expert called auditor in order to certify that financial statements give true and fair view of business.

2. Objects of auditing:

2.1 Main objective: In olden days the audit was done detect errors and frauds in accounting. But in modern days the audit is done in order to confirm that the financial statements drawn on the basis of books of accounts show true and fair view of business. To ensure and certify whether the profit and loss account shows the correct earnings and balance sheet gives the

true and fair view of business. To confirm that the accounts are not manipulated. Audit also ensures that whether the accounts are drawn as per the guidelines of various rules, statutes and acts governing the working of those firms such as Companies Act, SEBI guidelines, accounting standards etc.

2.2 Subsidiary Objectives: The secondary objectives of audit are:

(1) To detect errors and frauds in accounting;

(2) To prevent errors and frauds through proper mechanism of internal checks and internal controls.

3 Scope of Audit:

Normally the following matters should be included in the scope of audit.

1. An auditor has mainly to check that the **transactions are correctly recorded in the books** of accounts.
2. He has to verify that the transactions recorded in the books of accounts are **properly authenticated** and that they relate to activities of business.
3. To satisfy himself about the correctness of transactions recorded, he is required **to examine all the vouchers,** statements, contracts, minute books and relevant correspondence that would help him in such examination.
4. He should also be satisfied that the transactions are properly and **correctly posted** to the relevant ledger accounts and that the ledger accounts are correctly totaled and the balances are correctly carried forwards.
5. All the particulars shown in the **Balance Sheet should be vouched and verified** and it should be properly and correctly **valued**.
6. He should satisfy himself that all incomes and expenses have been **correctly allocated between capital and revenue.**
7. He has also to see that the accounts have been drawn up in accordance **with the legal requirements.**

4 Errors and Frauds

4.1 Errors - Meaning and Types: Errors are incorrect entries or omission of entries due to negligence or ignorance. “Error” means an unintentional mistake in financial information. It is an inadvertent or innocent (*bona fide)* mistake in the books and records.

A) Following are the different types of errors:

1. **Errors of Omission**

2. **Errors of Commission**
3. **Errors of Principle**
4. **Compensating Errors**

4.1.1 Errors of Omission: These errors arise when accountant fails to record a transaction wholly or partially. If a transaction is fully omitted it is called error of total omission. Such error does not affect the agreement of trial balance. Hence it cannot be detected through routine checking. If a transaction is partially recorded or posted it is called an error of partial omission. It affects the agreement of trial balance. Hence it is detected in routine checking. If goods sold to Mr. X are not recorded at all in the books of accounts or recorded but not posted to the account of Mr. X it is called error of omission.

4.1.2 Errors of Commission: Errors of commission arise when transactions are recorded in books of accounts in a wrong manner. The examples of errors of commission are incorrect entries, wrong casting, wrong posting, wrong calculations, mistakes in carry forward of balances etc. Generally these errors are revealed through non agreement of trial balance.

But some errors of commission such as wrong calculations made in invoice of sales do not affect the agreement of trial balance.

4.1.3 Errors of Principle: Errors of principle arise when the accounting is done against the principles of accounting. Examples of such errors are treating the capital expenditure as revenue expenditure or *vice versa*, ignoring outstanding expenses or revenues, valuation of assets in a wrong manner, writing the accounts ignoring the accounting standards etc.

For example, wages paid for the construction of building are treated as revenue expenditure and debited to wages account instead of debiting to building as a capital expenditure. Following are the examples of Errors of Principle.

1. Overvaluation or under valuation of Stocks.
2. Overcharging or undercharging Depreciation.
3. Treating revenue expenses as capital expenditure and *vice versa.*
4. Treating revenue expenses as deferred revenue expenses and *vice versa.*
5. Ignoring pre-paid or outstanding expenses.

6. Ignoring Income received in advance or income accrued.
7. Ignoring, over estimating or under estimating amount of Bad Debts or Provision for Doubtful Debts.
8. Over valuation or under valuation of an asset or a liability.

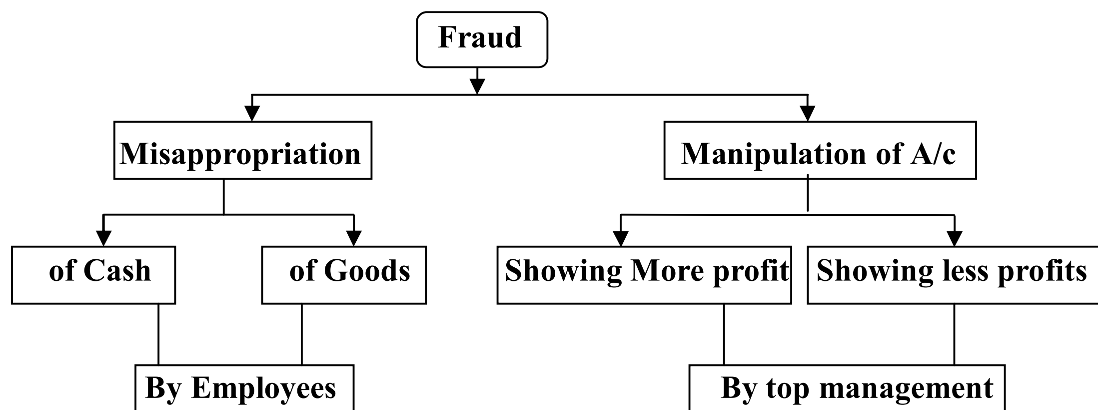
Such errors may be done unintentionally due to ignorance of accountant or may be done intentionally to manipulate the accounts. These errors are not disclosed by trial balance or through routine checking. Auditor has to verify the accounts in an intelligent manner in order to detect these errors.

4.1.4 Compensating Errors: Compensating Errors occur when the effect of one error is compensated by another error. Thus one error cancels the effect of another error and there in no final net effect on the accounts. For example, one sales bill No. 22 for Rs. 1,000 on B is posted into the account of A. Here B's account is under debited by Rs. 1,000 while A's Account is over debited by Rs. 1,000. These errors cancel each other and do not affect the trial balance. These errors, though difficult to trace, can be detected through vouching, obtaining statement of account or confirmations from parties, etc.

4.2 Frauds – Meaning and Types:

Fraud means false representation of transactions and events in the books of accounts with a view to defraud (or cheat) the owners of an enterprise. A "Fraud", is a deliberate and *mala fide* mistake to cheat or deceive someone.

The following types of frauds are usually common with accounts.



4.2.1 Misappropriation of Cash: Misappropriation of cash can be done in the following ways:

i) Omitting to enter cash received on debit side of cash book.

ii) Entering fewer amounts than what has been received.

iii) Showing fictitious payments on the payment side of cash book.

iv) Inflating the payments in the cash book.

v) *Teaming and Lading*: Teaming & Lading means that cash received from a customer is misappropriated and the cash received from another customer is posted to the first debtor's account and so on so as to misappropriate account.

Frauds i) and ii) above can be detected by counterchecking the payment side of cash book and rough cash book, counterfoils of receipts book, sales persons' reports, and such other evidences.

Frauds iii) & iv) above can be detected by proper vouching of cash payments, wage sheets, salary book etc. Teaming & lading can be detected by obtaining of confirmation of balances from auditors.

Misappropriation of cash can be minimized through proper internal check system, insisting the major payments through cheque, regular confirmation of balances of debtors and creditors.

4.2.2 Misappropriation of Goods: Where the system of internal check is not satisfactory, there are possibilities of misappropriation of goods by employees. There are more possibilities of misappropriation of goods when the goods are less bulky but of higher value. The management usually pays less attention to the defalcation of goods as compared to misappropriation of cash.

The following are some of the methods of misappropriating goods:

(1) Purchases: Goods might have been purchased, but the invoices may be suppressed and goods may be misappropriated. There may not be actual purchase returns, but some of the goods may be shown as purchase return and misappropriated.

(2) Sales: Goods might not have been sold but fictitious invoices may be prepared and goods shown as sold may be misappropriated. Or, in case of actual sale more goods may

be sent out and the excess goods sent may be misappropriated. Sales return may not be shown in the books and such goods may be misappropriated.

(3) Consumption: Excess consumption of materials may be shown in production department and goods may be misappropriated.

(4) Stock-taking: While stock taking some items may be omitted from stock-sheets and such items are misappropriated.

4.2.2.1 **Detecting Misappropriation of Goods**

An auditor has to be extremely careful and should take following steps to detect such frauds;

(i) In order to find out misappropriation of goods in respect of purchases, copy of order, goods received register and delivery chalan should be checked. Statement of accounts should be sent to creditors and their consent should be obtained.

(ii) In order to find out misappropriation of goods in respect of sales the sales invoices, orders received, copies of delivery chalan and goods outward register should be checked. Statements of accounts should be sent to debtors and their confirmation should be obtained.

(iii) In order detect fraud in connection with consumption of goods, material requisition note, material transfer note, bin cards and entries in stores ledger should be compared and checked.

(iv) If standards of consumption are pre-determined, then actual consumption should be compared with the standards.

(v) In respect of stock, the stock-sheets of current year should be compared with those of previous year and the value of stock of current year should be compared with the value of stock of previous year.

4.2.2.2 Prevention of Misappropriation of Goods :

(1) There should be an efficient system of internal check in respect of goods.

(2) A scientific procedure for purchase of materials should be laid down.

4.3 **Manipulation of Accounts**

Manipulations are frauds are committed by top management or owners of enterprise that does not involve misappropriation of goods or cash. The object of the manipulation of accounts is to show either more or less profit for different reasons.

4.3.1 **Reasons for showing Less profit :** The following objects induce the management to show less profit :

(1) To pay less income tax;

(2) To avoid the demands of employees for bonus or wage increase;

(3) To purchase shares at a lower price from the market.

(4) To mislead the competitors;

(5) To create secret reserve to be used in lean years.

4.3.2 **Methods of showing less profit :** The following are the methods by which the profit of the business is shown less than what it is :

(1) Over-valuing the opening stock

(2) Under-valuing the closing stock

(3) Showing fictitious purchases

(4) Suppressing the sales invoices

(5) Showing fictitious expenses

(6) Omitting some income from accounts

(7) Treating revenue receipt as capital receipt

(8) Showing less income receivable or expenses paid in advance

(9) Over-depreciating assets

(10) Providing more of bad debts reserve or discount reserve on debtors or less of discount reserve on creditors.

In short, items usually shown on debit side of Trading or Profit and Loss Account are overstated and those appearing on credit side are understated.

4.3.3 **Reasons for Inflating the Profits:** The profit of the business may be shown more than the actual one with following objects:

(1) To sell their shares at higher prices.

(2) To earn more commission if it is paid on the basis of profits.

(3) To create confidence in creditors to get credit.

(4) To attract investors to subscribe to the shares or debentures to be issued.

(5) To show higher efficiency to the shareholders, so that their services may be retained;

4.3.4 **Methods of showing higher profits:** The following methods are employed to inflate the profits of the business:

(1) Under-valuing the opening stock or over-valuing the closing stock

(2) Suppressing the purchase invoices or showing fictitious sales

(3) Showing fictitious incomes or omitting expenses

(4) Charging revenue expenditure as capital expenditure or treating capital receipts as revenue incomes

(5) Showing more income receivable or less expenses paid in advance

(6) Charging less depreciation of assets

(7) Making excess provision for discount on creditors.

In short, items generally shown on debit side of Trading and Profit and Loss Account are understated and those shown on credit side are overstated.

5. Basic Principles of Auditing:

The Institute of Chartered Accountant of India (ICAI) has laid down the basic principles which govern an audit [Standard Auditing Practices (SAP) - Statement 1]. Basic principles of audit guide an auditor as to how to conduct an audit and give an audit report.

(1) Integrity, Objectivity and Independence

The Auditor should be honest and sincere in his audit work. He should be fair and objective. He should not have any vested interest in the firm he is auditing.

(2) Confidentiality

The auditor should keep confidential the information obtained during audit. He should not disclose such information to any third party. He should, it is said, keep his eyes and ears open but his mouth shut.

(3) Skill and Competence

The auditor should have adequate training, experience and competence in auditing. He should have a professional qualification (i.e. a Chartered Accountant) and practical

experience. He should be aware of recent developments in the field of auditing such as statements of ICAI, changes in company law, decisions of courts etc.

(4) Review of Work Performed by Others

1. The auditor should carefully direct, supervise and review the work of his assistants.
2. He should satisfy himself that work done by an *internal auditor* is reliable.
3. He should satisfy himself that work done by another auditor (e.g. a *branch auditor*) is reliable.
4. He should satisfy himself that work done by a *joint auditor* is reliable.
5. He should satisfy himself that work done by an *expert* (lawyer, valuer etc.) is reliable.

(5) Working Papers

The auditor should maintain working papers of important matters to prove that audit was conducted with due care according to the basic principles.

(6) Planning

The auditor should plan his audit work. He should prepare an Audit Program to complete the audit efficiently and in time.

(7) Audit Evidence

The report of the auditor should be based on evidence obtained in the course of audit. The evidence may be obtained through vouching of transactions, verification of assets and liabilities, ratio analysis etc.

(8) Evaluation of Accounting System and Internal Control

The auditor should ensure that the accounting system is adequate. He should see that all the transactions have been properly recorded. He should study and evaluate the Internal Controls.

(9) Opinion and Report

The auditor should arrive at his opinion on the accounts on the basis of the audit evidence and submit his report. The opinion may be favorable or adverse. The audit report should clearly express his opinion. The content and form of audit report should be as required by law (e.g. Companies act).

6. Types of Audit:

Following are the types of audit: (1) Internal Audit (2) External Audit.

6.1 Internal Audit

In large business undertakings, numerous transactions take place every day. If proper control is not exercised over them, errors and frauds may be committed. In order to detect and prevent frauds and errors, the continuous audit is carried out by paid employees of the company. Some business undertakings appoint auditors for constant and regular checking of accounts. Such an arrangement is known as "Internal Audit", which is carried out in addition to the Statutory Audit.

6.2 Objectives of Internal Audit: Following are the important objectives of internal audit:

(1) To verify the accuracy of accounts and financial records;

(2) To detect and prevent errors and frauds;

(3) To improve the system of internal check;

(4) To ensure that the transactions of enterprise are properly authorized;

(5) To ensure prompt preparation of final accounts;

(6) To verifies compliance of the policies, plans and procedure laid down;

(7) To make a critical review of financial as well as operating activities of enterprise;

(8) To make valuable suggestions to the management to improve the efficiency of business;

(9) To make special investigations on request of management.

6.3 External Audit :

When a business unit appoints a professional auditor for a fixed remuneration, the audit carried out by such an auditor is called External Audit. The scope of such an audit depends upon the duties which the auditor accepts as per the law or as per the agreement with the client and he is required to carry on his audit work accordingly. The external auditor is required to give his report whether the accounts as examined by him shows true and fair view of the accounts and the true profit or loss of the business. The external auditor is accountable to the client for the work done by him. Sometimes he is liable to third parties also.

7 Internal check

Internal check system is based on the principles of division of labor. The system, whereby work of one employee is subjected to an independent check by another employee is called internal check. We shall now refer to some definitions of internal check given by distinguished authors on Auditing.

According to Spicer Y Pegler : "A system of internal check is an arrangement of staff duties, whereby no person is allowed to carry through and to record every aspect of a transaction so that, without collusion between two or more persons, fraud is prevented and at the same time the possibilities of errors are reduced to a minimum."

7.1 CHARACTRISTICS OF INTERNAL CHECK

The following are the characteristics of internal check:

1. Under this system the work of employees is defined and divided.

2. Work carried out by one employee is being continuously checked by another employee, and yet there is no duplication of work.

3. The accounts and records are not allowed to be under the complete and independent control of a single employee.

4. Accounts are subjected to a continuous audit.

5. The responsibility of the employee as regards work to be done by him is fixed.

6. The chances of errors, frauds and irregularities are minimised.

7.2 OBJECTS OF INTERNAL CHECK

The main objects of internal check system can be enumerated as follows :

(1) To detect errors committed by the employees and to prevent them.

(2) To detect frauds committed by the employees and to prevent them.

(3) To make the employees regular in their work by fixing their responsibilities.

(4) To fix up the responsibilities in regard to errors, frauds and discrepancies.

(5) To arrange for compilation of accounts regularly and systematically.

(6) To adopt the system of accounting by which final accounts are prepared without delay.

(7) To distribute work in such a way that no transaction is left out from being recorded in the books of accounts.

(8) To enhance the efficiency of employees.

(9) To keep a moral check on the employees.

7.3 ADVANTAGES OF INTERNAL CHECK

The wide use of internal check system is due to its following advantages :

Advantages to the Employer:

(1) Since there is proper division of work among staff members, the ***employees can better understand their sphere of work*** and responsibilities.

(2) The chances of ***errors and frauds are reduced*** to the minimum.

(3) The ***work is quickly and efficiently done*** since each employee knows his work and responsibilities.

(4) The owner of business is assured about the ***correctness of accounts*** and the can concentrate more on other important matters.

(5) The ***final accounts*** can be prepared ***promptly and easily***.

(6) There is a ***moral check on employees*** with the result that it leads to more *efficient and economic operations of business.*

Advantages to the Auditor :

(7) The ***auditor's work load is reduced*** where the internal check system is working efficiently. He need not do the detailed checking of accounts.

(8) Auditor can rely on the internal check system and ***can apply test checking***.

7.4 LIMITATIONS OF INTERNAL CHECK

Internal check has its own limitations which are as follows and must be taken care of:

(1) Where the system of internal check is in existence, *auditor sometimes becomes careless* since he takes it for granted that the accounts are correctly written. In reality, this may not always be so.

(2) The *employee* is also *likely to be careless* about the accounts on the assumption that the work is automatically going to be checked. The chances of errors and frauds therefore increases.

(3) The use of internal check system demands the services of many employees. For small businessman, it proves to be *expensive.*

(4) The *errors and frauds can be committed* if two or more employees join hands and the detection of such errors and frauds becomes very difficult.

However, it should be noted that the system of internal check is not inherently defective. If the system is implemented without adequate care, then only the above disadvantages my follow. In other words, they are not the disadvantages of the system but are merely its limitations. *It is said that Internal Check is both a pitfall and a safeguard.*

The system is advantageous in as much as it prevents the chances of errors and frauds and makes the employees more regular and diligent in performance of their duties. If the auditor becomes careless due to an efficient system of internal check, it is not the fault of the system. It is the duty of the auditor to see that the proper use of system is made. Of course, the principle of division of labour is applied in the internal check system, but if the employees join hands and commit frauds it will be difficult to detect such malpractices. In the words of *Joseph Lancaster.* ***"Internal check system does not abolish frauds and malpractices altogether but it certainly does reduce their chances."***

7.5 CHARACTERISTICS OF A GOOD INTERNAL CHECK SYSTEM

A good internal check system helps in detecting errors and frauds at the early stage. It is also intended to regularize the system of work by allocating the same to different employees and making them regular in performance of their duties. An ideal internal check system should, therefore, possess the following essential characteristics:

(1) ***Division of work****:* This, perhaps, is the most important feature of a good internal check system. The allocation of work, rights and responsibilities should be balanced and while dividing the work the level of intelligence, competence, likes and dislikes of various employees should be taken into account so that the work allotted to them is accomplished in a more efficient manner.

(2) ***Dependence****:* Each item of work should be so allocated that no individual employee is allowed to handle all aspects of a single transaction. The division of work should be such that it will compel one employee to depend on the other, thus minimizing the possibilities of errors and frauds.

(3) ***Planning the procedure****:* The procedure of work should be laid down simultaneously with the division of work so that the employees to whom a particular work is allotted can carry out the same quickly.

(4) ***Information in regard to policy matter****:* The employees should be given information about the business policies so that they can work accordingly.

(5) ***Change of duties****:* Even if the work is properly divided, the chances of collusion cannot be eliminated altogether. As a precaution, the employees should be transferred from one job to another and their duties should thus be changed at intervals, without notice.

(6) ***Compulsory leave****:* The employee should be encouraged to go on leave and his work should be performed by another employee. Thus fraud, if any, committed by the employee on leave will be easily detected.

(7) ***Security Deposit****:* Persons employed on the posts of cashier, storekeeper or accountant should be asked to pay security deposit. If any fraud or defalcation is committed by such employees, the same can be recovered from such deposits.

(8) ***Depositing cash in bank:*** Where the cash dealings are considerable it is advisable that cash collection should be deposited in the bank daily. As far as practical, payments should be made by cheques only.

(9) ***Self-balancing ledgers:*** Self-balancing system should be introduced so that no employee has complete knowledge of the working of the entire business and responsibility of ledger keeper if fixed.

(10) ***Flexibility****:* Internal check system should be flexible and not rigid, in the sense that there should be scope for making necessary changes according to changes in circumstances and conditions of the business.

(11) ***Mechanized Accounting****:* If accounting is done with the help of machines and computers, the chances of mistakes are eliminated. The work is also carried out accurately and efficiently. Machines like computers, time recording clocks, franking (stamp) machine, accounting and cash recording machine etc. should be used wherever possible.

(12) ***Use of reports****:* The employees should be asked to submit the report of their work at periodic intervals. This will help the management to know the quantum of work done by each employee. It will also reflect the efficiency or otherwise of the employees working in different sections.