2

INTRODUCTION TO AUDITING II

STRUCTURE:

2.0 OBJECTIVES

After studying the unit the students will be able to

- Understand the meaning of Errors and Frauds
- Classify the reasons and circumstances of errors and frauds.
- Explain the types of Errors and fraud
- Elaborate the Authors duty in case of Errors and frauds.
- Explain the types of Audit
- Understand the principles of Audit

2.1 MEANING AND DEFINITION OF ERRORS AND FRAUDS

DEFINITIONS :

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

(a) Principal Errors and (b) Clerical Errors

(a) principal Errors 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.

2.2 REASONS AND CIRCUMSTANCES

R.K. Mautz, has classifieds the reasons and circumstances of errors and he has include fraud in the broad category of errors. The classifications are the following.

1. ignorance on the part of employees of accounting development, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortage of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever presents desires to hold taxes on income to minimum.

A sixth cause may be added to those Mr.Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in positions of authority to :

I. Show up the picture depicted by the statements;
II. Depress the picture depicted by the statements; and
III. Convert the error to a personal benefit.

2.3 TYPES OF ERRORS

2.3.1 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.

2.3.2 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.

2.3.3 Principle and compensating

PARTICULRS	PRINCIPLE	COMPENSATING
MEANING	A Transaction Is Basically Recorded In The Books In An Incorrect Manner.	An error which is counter balanced by another error, so that it is not disclosed by the trial balance.
Types.	(a) **errors which do not affect profit:** e.g. manufacturing wages posted to trade expenses A/C or wrong classification of assets or Liabilities. (b) **Error which affect profit :** e.g. treating rent paid as a debtor instead pf as expenses, when capital expenditure is treated as revenue and debited to P&L account.	It may or may not affect profit. If both original and compensating errors arise in revenue accounts, profit will not be affected, but if one arises in a revenue account and other in an asset or liability account, trial balance will agree, but profit will be incorrectly stated. It arises in various ways, most frequently in casting, e.g., cast of expenditure account may be Rs.96,000 too much, profit and asset being thereby shown improperly.
3 Effect on trial balance.	These errors will not affect the trial balance.	These errors will not affect the trial balance.
Effect on profit	Error that involves income and expenditure a/c e.g. wrong distinction between capital and revenue	Compensating errors, involving income and affect profit. But if error is in asset and liability accounts only, profits may not be

	expenditure will affect profit.	affected.
Detection	These errors are detected by audit procedures like analytical reviews, ledger scrutiny, analysis of comparative financial statements, etc.	Such errors are generally deliberately concealed and hence difficult to detect. Audit procedures like analytical review, posting checking, ledger scrutiny, etc. can partly help to locate these errors.

2.4 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.

2.4.1 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."

2.4.2 Misappropriation of Cash

Misappropriation of cash is also called embezzlement of cash. It means fraudulent appropriation of cash belonging to another person by one who has been entrusted to it. Misappropriation may take place in the following ways:

1) Not recording full cash sales and pocketing a part of the proceeds
2) Teeming and Lading
3) Misappropriation the money received from sale of goods sent on sale or return basis
4) Making fictitious entries in customer's accounts for bad debts, discount etc.
5) Misappropriation the amount received from sale of defective goods by not recording such sale
6) Recording fictitious cash purchase
7) Recording payments to fictitious creditors
8) Not recording discounts received from creditors
9) Recording payments to dummy or ghost workers and pocketing the money, etc.

2.4.3 Misappropriation of Goods

It refers to fraudulent application of goods by those who handle them. It can be done by recording sales of larger quantities and misappropriating the balance or by recording purchase of large quantities receiving less quantity and then receiving the balance amount privately.

2.5 RISK OF FRAUD AND ERROR IN AUDIT

The following events may increase the risk of fraud or error -

1. **Internal Control Faults:** Weaknesses in the design of internal control system and non-compliance with laid down control procedures, e.g. a single person being responsible for receipt of all pasts/ mails and marking it ti the relevant secions or two persons responsible for receipt of all posts/ mails but the same is not followed in the practice.

2. **Doubts about the integrity or competence of the management,** e.g. domination by one person, high rate of employee turnover, frequent change of legal counselsof Auditors, significant and prolonged understaffing of the accounts department, etc.

3. **Unusual pressures within the entity,** e.g. industry is doing well but the Company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support the share market price, etc.

4. **Unusual transactions** e.g. transactions with related parties, excessive payment for certain services to lawyers, etc.

5. **Problems in obtaining sufficient and appropriate audit evidence,**
   E.g. inadequate documentation significant differences between the figures as per accounting records and confirmation received from third parties. Etc.

2.6 AUDITOR'S DUTIES AND RESPONSIBILITIES IN RESPECT OF FRAUD

The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error.

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

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement pf the financial statement resulting from fraud or error does not, in and of itself, indicates:

a) Failure to obtain reasonable assurance,
b) Inadequate planning, performance or judgment,
c) Absence of professional competence and due care, or,
d) Failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management. Those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's reports based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error. Which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

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

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

2.7 BASIC PRINCIPLES OF AUDIT

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

1. Integrity, objectivity and independence:
The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever it's actual effect, as being incompatible with integrity and objectivity.

2. Confidentiality:
The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is legal or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.

3. Skill and competence:
The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying

examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others:

When the auditor delegates work to assistant* or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise & review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.

5. Documentation:

The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning:

The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.

7. Audit evidence:

The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.

8. Accounting system & internal control:

The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

9. Audit conclusions and reporting:

The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.

2.8 AUDIT TYPES

MEANING:

Audit is not legally obligatory for all types of business organizations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

(i) Audit required under law : The organizations which require audit under law are the following:

(a) companies governed by the Companies Act, 1956;
(b) banking companies governed by the Banking Regulation Act, 1949;
(c) electricity supply companies governed by the Electricity supply Act, 1948;
(d) co-operative societies registered under the co-operative Societies Act, 1912;
(e) public and charitable trusts registered under various Religious and Endowment Acts;
(f) corporations set up under an Act of parliament or State Legislature such as the Life Insurance Corporation of India.
(g) Specified entities under various sections of the Income-tax Act, 1961.

(ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. in respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purpose like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited.

Government companies have some special feature which will be seen later.

INTERIM AUDIT:

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

CONTINUOUS AUDIT:

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

A continuous audit is preferred for the following reasons:

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

2.9 ACCOUNTING CONCEPT RELEVANT TO AUDITING

INTRODUCTION

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

2.9.1 MATERIALITY:

1. Information is material if its misstatement (i.e., omission or erroneous Statement) could influence the economic decisions of users taken on the Basis of the financial information. Materiality depends on the size and Nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

2. The objective of an audit of financial information prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is materiality of professional judgment.

3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity at

both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and consideration relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

4. Although the auditor ordinary establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misted by the description.

5. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedures could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.

6. Materiality should be considered by the auditor when-

(a) Determining the nature, timing and extent of audit procedures;

(b) Evaluating the effect of misstatements.

2.9.2 GOING CONCERN:

1. The purpose of this Auditing and Assurance standard (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuous as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, asset and liabilities are recorded on the normal course of business. If this assumption is unjustified, the entity

may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statement may need to be adjusted.

APPROPRIATENESS OF THE GOING CONCERN ASSUMPTION

I. The auditor should consider the risk that the going concern assumption may no longer be appropriate.

II. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

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