Diploma in Financial Management & Accountability

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Course Material

Audit

Paper - VII

Module - IV

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UNIT- 2
BASIC CONCEPT OF AUDITING

2.1. AUDIT EVIDENCE

Audit evidence refers to any information, verbal or written, obtained by the auditor in arriving at the conclusion on which he bases his opinion on financial statements. In fact all assertions expressed or implied in a transaction recorded in the books of accounts have got to be evidenced in one way or the other. The evidence may be of varied nature and can assume various forms such as a signature on the voucher of a designated official, the payee's receipt, acknowledgement from the stores for the goods received, supplier's invoice, statement of account, minute's of contracts, etc. Even the information obtained by the auditor by discussing with the officials of the company also constitutes audit evidence.

2.1.1. Need for Audit Evidence

Auditing is a logical process. An auditor is called upon to comment on the actualities of the situation and to comment whether the statement of account prepared, present a true and fair view. This he cannot do unless he has examined the statement of accounts objectively. Objective examination is the critical examination and scrutiny of the accounts of the organisation with a view to assessing how far the statements present the true and fair view. An opinion founded on the reckless and negligent course of examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

AAS-1 on "Basic Principles Governing an Audit" require that the auditor needs to obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedure to enable him to draw reasonable conclusions there from on which the auditor should base his opinion on the financial information. Therefore, evidence is required by the auditor to enable him to express an opinion on financial statements.

2.1.2. Type of Evidence: Internal Evidence & External Evidence

Internal Evidence is one that has been created, used and retained within the client's organization. The examples of internal evidence are sales invoice duplicate copy, employee's time reports, inventory reports, purchase requisitions, minute books, etc. Further these may not always constitute a direct accounting source document.

External evidence on the other hand, is one which originates from outside the client's organization. A document issued by person with whom some business transaction had been entered into or who paid or was advanced an amount constitutes such evidence, e.g., payee's bank statement, insurance policies, mortgage deeds, etc. These documents are prepared in the ordinary course of business activities and form part of its records.

Sometimes, in certain transactions, external evidence is obtained directly by the auditor, e.g., certificate regarding bank balance, balance confirmation of debtors and creditors. External evidence is considered more reliable than the internal evidence.

2.1.3. Main Methods of Obtaining Audit Evidence

a) **Inspection:** Inspection consists of examining records, and documents and it provides evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Four major categories of documentary evidence, which provide different degrees of reliability to the auditors are:

- Documentary evidence originating from and held by third parties;
- Documentary evidence originating from third parties and held by the entity'
- Documentary evidence originating from the entity and held by the third parties; and

- Documentary evidence originating from and held by the entity.

b) **Observation:** Observation is witnessing a process or procedure being performed by other. For example, the auditors may observe the counting of inventories by clients' personnel.

c) **Inquiry and Confirmation:** Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Response to inquiries may provide the auditor with information which he did not previously posses or may provide him with corroborative evidence. For example, the auditor requests confirmation of receivables by direct communication with debtors.

d) **Computation:** Computation consists of checking the arithmetical accuracy of source documents and accounting records and performing independent calculations.

e) **Analytical Review:** Analytical Review consists of studying significant ratios and trends and investigations of unusual fluctuations and items. The timing of such procedures will be dependent in part, upon the periods of time during which the audit evidence sought is available.

2.2. ERRORS & FRAUDS

Errors and frauds both distort the true picture either by omission or by commission but the distinction between the two lies in intent. Error is an involuntary act whereas fraud is a deliberate act.

The error can be classified as:

i) Self-revealing and non-self-revealing errors;

ii) Intentional & un-intentional error

Self-revealing and not self-revealing errors

Self-revealing errors are such errors, the existence of which becomes apparent in the compilation of accounts. An example of such error is:

A mistake in recording amount received from X in the account of Y.	Statement of account parties will reveal the mistake

Other errors which are not revealed in the process of compilation of accounts are know as non-self-revealing errors. Such mistakes may remain un-detected indefinitely unless measures aimed at discovering such errors are applied. An example of such error is :

An item of expense which should have been charged to Repairs A/c has been charged to the Building A/c or the amount of depreciation calculated incorrectly.

Un-intentional error

Fraud is the word used to mean intentional error. This is done deliberately which implies that there is intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal, they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.

As per AAS-4, "Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements:

Fraudulent Financial Reporting

It involves intentional mis-statements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve :

i) Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.

ii) Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.

iii) Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

Misappropriation of Assets

It involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

Therefore, it is clear from the above that the `fraud' deals with intentional misrepresentation but, `error', on the other hand, refers to unintentional mistakes in financial information.

2.3. CONCEPT OF TRUE AND FAIR

The concept of true and fair is fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies, that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verifying that all assets, liabilities, incomes and expenses are stated at amounts which are in accordance with accounting principles and policies which are relevant and no material amount, items and transaction has been omitted.

What constitute true and fair, however, has not been defined in any legislation. In the context of a company, Section 211(5) of the Companies Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to the disclosed by virtue of provisions of Schedule VI to that Act, unless by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the accounts must be drawn up in conformity with the provisions of Schedule VI and they must contain all the matters required to be disclosed therein. In case of companies, which are governed by special Acts, it should be seen whether the disclosure requirements of the governing Act are complied with. It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus what constitutes a `true and fair' view is a matter dependent on particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see :

- That the assets are neither undervalued, nor overvalued according to the applicable accounting principles
- No material asset is omitted.
- The charges, if any, on assets are disclosed.
- Material liabilities are not omitted.
- Liabilities are neither over valued nor under valued and the same are properly classified.
- The Profit and Loss account discloses all the matters required to be disclosed by Part II of Schedule VI and the Balance Sheet has been prepared in accordance with Part I of Schedule VI.
- Accounting policies have been followed consistently.
- All unusual exceptional or non-recurring items have been disclosed separately.

2.4. FUNDAMENTAL ACCOUNTING ASSUMPTIONS

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumptions :

(a) **Going Concern**: The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing.

(b) **Consistency:** It is assumed that accounting policies are consistent from one period to another.

(c) **Accrual:** Revenues and costs are accrued, that is recognized as they are earned or incurred (and not as money is received or paid) and recognized in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this statement.)

If the fundamental accounting assumptions, viz, Going Concern, Consistency and Accrual are followed in financial statements specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

2.5. VOUCHER

A Voucher is a documentary evidence in support of any transaction in books of accounts. Vouchers can originate within the organisation or outside the organisation i.e. they can be internal or external.

Vouchers originating within the organisation are invoices for Sales, receipted Bank counterfoils, correspondence, gatekeeper's note, pay in slip of bank, a resolution passed in any meeting of shareholders, material requisition slip etc.

2.6. VOUCHING

Vouching is an inspection by an auditor of documentary evidence supporting and substantiating transactions. The aim of vouching is to establish that all the receipts and payments are properly accounted for and that no fraudulent payments are recorded. *Thus, vouching is to establish by means of documentary evidence that the transaction is properly recorded and accounted for.*

Vouching is a substantive audit procedure designed to obtain evidence as to completeness, accuracy and validity of the data produced by the accounting system. *The purpose of vouching is to determine that:*

a) a transaction is recorded in proper account and revenue or expense is allocated to proper accounting period.
b) a transaction pertains to the entity that took place during the relevant period.
c) all transactions which have actually occurred have been recorded.
d) accurate amount has been recorded.
e) transactions have been classified and disclosed in accordance with recognized accounting policies and practices.

Vouching is also the basis for verification of assets and liabilities. For example, let us take an asset like sundry debtors. The auditor has to certify that it is correctly stated in the Balance Sheet. For this he has to check the account of every debtor. This means that he has to vouch, the entries in the Sales Book, Sales Return Book, Cash Book, Bills Receivable Book and Journal in relation to debtors. He has to compare the entries with vouchers like invoices, credit notes, duplicate receipts correspondence and minutes, verify the postings into debtor's account, and see that bad debts, are written off and adequate provision has been made for doubtful debts.

Hence, auditor should be careful while vouching the transaction and entries in the books of accounts. It is the backbone of auditing process. The success of auditing depends, upon vouching also. *If vouching is done with proper care, and imagination, it would go a long way in establishing the reliability of financial statements. Thus, vouching may be considered as the essence of auditing.*

2.7. VERIFICATION OF ASSETS

Verification of assets is an important audit process, by convention its scope has been limited to inspection of assets, where it is practicable and collection of information about them in an examination of documentary and other evidence so as to confirm :

a) That the assets were in existence on the date of Balance Sheet;

b) That the assets have been acquired for the purpose of the business and under a proper authority;

c) That the right of ownership of the assets vested in or belonged to the undertaking;

d) That they were free from any lien or charge not disclosed in the Balance Sheet;

e) That they have been correctly valued having regard to their physical condition; and

f) That their values are correctly disclosed in the Balance Sheet.

2.8. VERIFICATION OF LIABILITIES

The auditor has to report whether the Balance Sheet shows a true and fair view of the state of affairs of the company and Profit and Loss Account shows a true and fair view of the profit or loss for the period under audit. If liabilities are not provided for in respect of expenses incurred or in respect of the income received in advance both the Balance Sheet and the Profit and Loss Account would not show true and fair picture. Hence, the auditor should see that the provision is made in respect of all the known liabilities. He should verify all liabilities in the Balance Sheet. Besides, he should have a certificate from the top management or a partner or proprietor that a provision has been made in respect of all the known liabilities. He should see that purchases are not suppressed. When the goods are received and either consumed or sold or taken into closing stock, the purchase of such goods must be recorded.

The auditor should verify that all the outstanding liabilities are recorded fully. Accrued expenses must be recorded. An understated liability has the effect of overstating the income and also the net worth. A liability should not be overstated also. All genuine liabilities must be provided for. An overstatement of liabilities may lead to fraudulent disbursements. In normal course of checking these can be uncovered.

SELF ASSESSMENT QUESTIONS

i) What is an `Audit Evidence'?

ii) Why does an Auditor need evidence?

iii) Define internal evidence and external evidence.

iv) Suggest evidence (one external and one internal evidence) in respect of the following :

- **Rent paid for the office premises**
- **Rent paid to the resource persons for conducting training programmes**
- **Balance with banks**
- **Amount paid for purchase of medicines**
- **Amount paid for salaries.**

v)	**Differentiate between Error and Fraud.**
vi)	**What is self-revealing and not self-revealing error and give one example of each of the errors.**
vii)	**Discuss the concept of `true & fair'.**
vii)	**What are the fundamental accounting assumptions?**
ix)	**What is vouching?**
x)	**Why verification of assets and liabilities are important?**