



## UNIT- 9

## Auditing

### Learning Outcomes

**By the end of this unit the learner will be able to:**

- ✓ Explain what an Audit is?
- ✓ Discuss why are audits carried out?
- ✓ Describe six parts of an audit report
- ✓ Understand the types of audits.

## Unit 9

### Auditing



#### What is an Audit?

An audit is basically an examination of the accumulation of financial records, in order to determine if such records and, or financial statements are in accordance with the rules of Generally Accepted Accounting Principles or (GAAP). An audit can also help to determine if all records are free from any errors or material misstatements, or fraud. Any discrepancies may be reported to the Internal Revenue Service (IRS).

Interestingly enough, the practice of auditing is not only unique to present day government structures. Auditing was first introduced under the reign of Queen Elizabeth I in 1559, who established the Auditors of the Empress. They were responsible for auditing the exchequer payments. But even before then, there is said to have been a public official charged with auditing government expenditure as an Auditor of the Exchequer in 1314 England. Queen Elizabeth's system, however did not sustain. Then finally in 1780, statute appointed the Commissioners for Auditing the Public Accounts



## When and Why Would You Audit?

As stated above, an audit is usually done to make sure everybody is on the same page and appropriately and legally preparing their records in accordance with the proper rules and regulations of the (GAAP). Let's not also forget about "BIG BROTHER" "UNCLE SAM" or whatever you choose to call that big government agency in the sky (No, not that one yet, let's assume you're still alive and kicking for the purposes of this training), but yes we are talking about the IRS. An audit, unlike accounting, is not concerned about the preparation of the proper documents, but is most concerned if they were prepared correctly and according to the guidelines of (GAAP) and free of fraud. There are six parts of every audit report, which include: the report title, the report address, the introductory paragraph, the scope paragraph, opinion paragraph, and the lastly the signature of CPA firm. Keep in mind the order may vary from auditor to auditor, but for the most part, the audit should contain all the elements listed above.

The best time to do an audit would probably be, when you are prepared to handle the stress of actually going through one. For the people who took this course, no worries, because you have all been taught to do everything the right way. For the rest, they might need to take a towel to collect all the sweat their going to accumulate during the audit. All joking aside, an audit is usually done before the release of the financial statements, but typically on an annual basis, before the end of each year.



## Internal

There are two kinds of audits, internal and external. An internal audit is usually done by someone hired by a company or within the company, and doesn't necessarily have to be a CPA (Certified Public Accountant). For the purposes of internal audits, some companies may have CIA's, no not the Central Intelligence Agency, but a Certified Internal Auditor.

There is also a governing agency called (IIA), which is called the Institute of Internal Auditors. An internal audit is designed to add value and improve an organization's operations, as well as improve the effectiveness of risk management, control, and governance processes. When there is room for improvement, an internal auditor may make suggestions, or recommendations for enhancing, processes, policies, and procedures.



## External

An external audit is an audit that is done periodically by an independent entity, one outside of a company, to determine if accounts are accurate and complete, prepared in accordance with the regulations of the GAAP, and that the financial records have been done fairly, and appropriately.



## Objectives of Auditing

There are two main objectives of auditing.

The primary objectives and the secondary or incidental objectives.

**Primary objective** –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 or loss for the financial year.

**Secondary objective** – it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objectives of auditing are:

- Detection and prevention of Frauds, and
- Detection and prevention of Errors.

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.

### Detection of Fraud & Errors

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.

- Defalcation involving misappropriation of either cash or goods; and
- Fraudulent manipulation of accounts not involving defalcation.

## Fraud Covers The Following

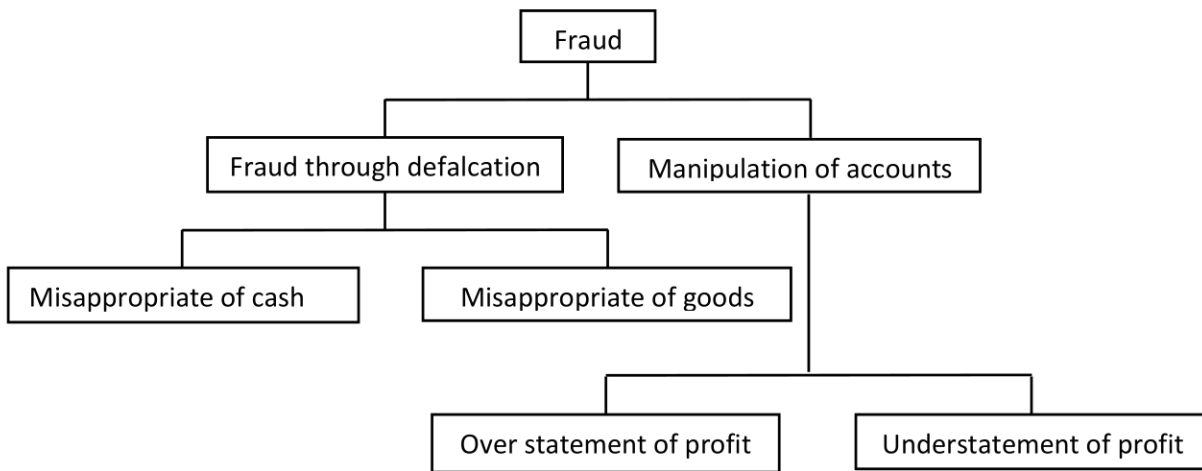


Table: 9.1

### Fraud through Defalcation

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

1. By misappropriating the receipt by not recording the same in the cashbook.
2. By destroying the counter foil of the receipt and misappropriating the cash received.
3. By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book.
4. By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.
5. By omitting to record cash donations received by non-profit making charitable institutions
6. By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.
7. By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.
8. By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.
9. By under casting receipt side total of the cashbook
10. By recording fictitious or bogus payments
11. By recording more payments than actual amounts paid by altering the figures on the vouchers.
12. By showing the same payment twice.
13. By showing credit purchases as cash purchases and misappropriating the amount.
14. Recording personal expenses as business expenses.
15. By not recording discounts and allowances given by the creditors and misappropriating the amounts
16. Recording fictitious and inflated purchases and misappropriating that amount.
17. By suppressing the credit notes for returns and showing the full payment to creditors.
18. By including the names of dummy workers or the workers who have? The job in the wage sheets and misappropriating the amount.

19. By over casting the total of wages sheets and drawing that amount for misappropriation.
20. By misappropriating the undisbursed wages.

### Fraud through Manipulation of Accounts

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Generally this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

### How can Auditors detect fraud?

The Auditor Can Suspect Fraud under the Following Circumstances:

1. When vouchers, invoices, cheques or 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 is difference between the balance and the confirmation of the balance by the parties.
5. When there is difference between the stock as per records and the stock physically counted.
6. When the explanation given by the client is not satisfactory.
7. When there is a overwriting of some figures.
8. When there is a contradiction in the explanation given by different parties.

### Procedure to Be Followed for Detecting 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 £ 1,000; £ 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.

## Auditors' Duties & Responsibility for Fraud Detection

The Auditor should perform the following Duties when detecting fraud:

1. Examine all aspects of the finance.
2. Vouch all the receipts from the counterfoils or cash memos, sales mart reports etc.
3. Check thoroughly the salary and wages record.
4. Verify the methods of valuation of stocks.
5. Checkup stock record, goods inwards notes, goods out wards books and delivery 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. Make surprise visit to check the accounts.

## Advantages and Inherent Limitations of Audit

### Advantages of audit

A. Businessman's point of view	B. Investor's point of view	C. Other Advantages.
1. Detection of errors and frauds	1. Protects interest	1. Evaluate financial status
2. Loan from banks	2. Moral check	2. Gives shareholders confidence
3. Builds reputation	3. Proper valuation of investments	3. Settlements of claims
4. Proper valuation of assets	4. Good security	4. Evidence in court
5. Government acceptance		5. Settlement of accounts
6. Update accounts		6. Facilitates calculation of Purchase.
7. Suggestions for improvement		7. Facilitates taxation
8. Useful for agency		

Table: 9.2

### Limitations of Auditing

Generally following are the Limitations of auditing

- **Non-detection of errors/frauds:-** Auditor may not be able to detect certain frauds which are committed with malafide intentions.
- **Dependence on explanation by others:-** Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.

- **Dependence on opinions of others:-** Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc. s/he cannot be an expert in all the fields
- **Conflict with others:** - Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgment plays an important role. It differs from person to person.
- **Effect of inflation:** - Financial statements may not disclose true picture even after audit due to inflationary trends.
- **Corrupt practices to influence the auditors:** - The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.
- **No assurance:** - Auditor cannot give any assurance about future profitability and prospects of the company.
- **Inherent limitations of the financial statements:** - Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts cannot be measured. Audited statements due to these limitations cannot exhibit true position.
- **Detailed checking not possible:** - Auditor cannot check each and every transaction. He may be required to do test checking.

### **In order to show a true and fair view the auditor should ensure that:**

1. The final accounts agree with the books of accounts.
2. The provision for depreciation is proper.
3. The closing stock is physically verified and valued properly.
4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.
5. Proper provision is made for bad and doubtful debts.
6. Capital expenses are not treated as revenue expenses and vice versa.
7. Capital receipts are not treated as revenue receipts.
8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.
9. Contingent liabilities are not treated as actual liabilities and vice versa.
10. Provision is made for all known losses and liabilities
11. A reserve is not shown as a provision and vice versa
12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.
13. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income is recorded properly.
14. Expected or anticipated gains are not credited to the profit and loss account.

15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly
16. The exceptional or non-recurring transactions are disclosed separately in the accounts.

### Qualities of an Auditor

The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor.

An Auditor must have the highest degree of integrity backed by adequate independence.

An Auditor must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact.

An Auditor must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. The Auditor must know thoroughly all accounting principles and techniques.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

### Further Reading:

- ✓ *Charles B. Hall, (2019), The Why and How of Auditing: Auditing Made Easy.*
- ✓ *Michael P. Griffin, (2017), Auditing: A Quickstudy Reference Tool.*
- ✓ *Graig Cochran, (2017), Internal Auditing in Plain English: A Simple Guide to Super Effective ISO Audits.*