Chapter 1

AUDITING – BASIC CONCEPTS & ETHICAL ASPECTS

CHAPTER OVERVIEW

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Note: Also refer SA–200, SA–210, SA–240, SA–250, SA–620 and SA–700 in respect of concepts discussed in this Chapter.

1.1 BASICS

1.1.1 General Purpose Financial Statements

1. **Financial Statements** includes the following –
   (a) Statement of Performance — Profit and Loss Account,
   (b) Statement of Financial Position — Balance Sheet,
   (c) Statement of Movement of Funds — Funds Flow and Cash Flow Statement.
   (d) Significant Notes to Accounts — Related Notes
2. **Entities interested** in financial information:

Users	Purpose
Management	For day–to–day decision–making and **performance evaluation**.
Proprietor / Shareholders	To analyse performance, **profitability** and financial position. **Note:** Prospective investors are interested in the track record of the Company.
Lenders–Banks & Fin. Institutions	To determine the financial position and **strength** of the Company, Debt Service Coverage, etc.
Suppliers	To determine the **credit worthiness** of the Company.
Customers	To know the **general business viability** before entering into long–term contracts and arrangements.

Users	Purpose
Government	• To ensure prompt collection of Direct and Indirect Tax revenues, • To evaluate performance and contribution to social objectives.
Research Scholars	For study, **research** and analysis purposes.

3. **Financial Reporting Framework**:
   (a) Financial Statements are ordinarily prepared and presented annually and are directed towards the common information needs of a wide range of users.
   (b) Such Financial Statements need to be prepared in accordance with one, or a combination of –
   - Relevant Statutory requirements (e.g. The Companies Act, for Companies, etc).
   - Accounting Standards issued by the ICAI and
   - other recognised accounting principles and practices (e.g. Guidance notes issued by ICAI)

   (c) Thus the basis on which the Financial Statements are prepared, are called as Financial Reporting Framework.

   Note: Applicable Financial Reporting Framework means a framework adopted in the preparation and presentation of financial statements that is acceptable in view of the nature of the entity and the objectives of the Financial Statements or that is required by law or regulation.

1.1.2 Auditing – Definition

1. **Origins of Auditing:**
   (a) We are able to find references of auditing in Kautilya's Arthashastra (a 4th Century Book). This book talks of Fixed Accounting year and process for closure of accounts as at the end of the period and audit (Periodical checking and verification) of the same.
   (b) The Term "Audit" finds its origin from the Latin Word "Audire" [Meaning "to Hear"]. This is due to the fact that in the medieval ages, auditors used to hear the accounts read out to them to check for carelessness and negligence.
   (c) In India the Institute of Chartered Accountants of India (ICAI) was established as a statutory body under an act of parliament in the Year 1949 for regulating the profession of Auditing (and Chartered Accountancy) in the Country.

2. **Definition [SA 200]:** Audit is an 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.

3. **Reliance and Confidence:** The above users (entities interested in Financial Information) of Financial Statements who use financial information for various purposes as stated above according to their respective requirements, place reliance on the audited financial statements. This reliance is placed due to the confidence and assurance provided to the above users.

   Note: The level of Assurance, reliance that can be placed on the Financial Statements and the Liabilities of the Auditors for the same is discussed at the relevant places in the upcoming chapters

1.1.3 Assurance

1. **Meaning:** The term "Assurance" refers to the Auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party. To provide such assurance, the Auditor assesses the evidence collected as a result of procedures conducted and expresses a conclusion.

2. **Engagement:** In general terms, the term "Engagement" means an arrangement to do something. In relation to Audit, this refers to the formal agreement between the auditor and the client (Auditee) under which the auditor agrees to conduct and provide auditing services. This usually takes the shape of a written engagement letter.

3. **Assurance Engagement:** Assurance Engagement means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users (Except the responsible party) about the outcome of the evaluation or measurement of a subject matter against criteria.
   This means that the Practitioner expresses an opinion on specific information, which allows users to make informed and confident decisions, knowing that the likelihood of the information being incorrect is reduced.

4. **Types of Engagements:** The degree of satisfaction achieved and therefore the level of assurance which may be provided is determined by the procedures performed and their results. The following types of Engagements are relevant –

Type of Engagement	Description	Applicable Standard
(a) **Audit Engagement**	• Applicable only for Historical Financial Information. • Auditor provides a high, but not absolute, level of assurance that the information subject to audit is free of material mis–statement. (**Positive Assurance**)	Standards on Auditing (SAs)
(b) **Review Engagement**	• Applicable only for Historical Financial Information. • Auditor provides a moderate level of assurance that the information subject to review of free of material misstatement. (**Negative Assurance**)	Standards on Review Engagements (SREs)
(c) **Assurance Engagements**	• Applies for matters other than Historical Financial Information. • Applicable for Assurance Engagements other than Audit and Review, e.g. Verification of Projections, Forecasts, etc.	Standards on Assurance Engagements (SAEs)
(d) **Related Services**	• Applicable for "agreed upon procedures", or other related services, e.g. Compilation of Financial Information.	Standards on Related Services (SRSs)

5. **Elements of Assurance Engagements:**

Element	Description
Tripartite Relationship	Assurance Engagement involves 3 Parties as follows: (a) **Practitioner:** Person providing assurance services [Practitioner ≠ Auditor – refer Note] (b) **Responsible Party:** Person responsible for the preparation of the subject matter (c) **Intended Users:** Persons for whom the assurance report is prepared (who use it for varied decision making purposes)
Subject Matter	This refers to the information to be examined by the practitioner
Criteria	Criteria are the benchmarks used by the practitioner to evaluate the subject matter against. (Eg: Accounting Standards, Laws, Regulations, etc.)
Evidence	The essence of the assurance engagements is the opinion that is given by the practitioner. This opinion is formed by the practitioner only by reaching conclusions which are based on sufficiency (Quantitative) and appropriateness (Qualitative) of the evidence.
Reporting	Reporting is done through a written report that conveys the assurance about the subject matter. This written report is the final outcome of the assurance engagement

Note: The Term Practitioner is much broader when compared to the term Auditor. While the term Auditor deals with audit (providing reasonable assurance engagements) performed on historical financial information, the term practitioner deals with all engagements (Audit, Limited Review, Other Assurance engagements).

6. **Assurance Aspects in Audit:** Auditing is not mere comparison of Books of Accounts with Supporting Documents. The Auditor has to express his opinion on the Financial Statements after satisfying himself that –
   (a) **Books:** The accounts have been drawn up with reference to entries in the books of account,
   (b) **Evidence:** The entries in the books of account are supported by adequate documentary evidence,
   (c) **Full Inclusion:** All entries in the books of account have been considered in the process of preparation and compilation of Financial Statements,
   (d) **Clarity:** The information conveyed by the Financial Statements is clear and unambiguous,
   (e) **Disclosure:** The amounts in the Financial Statements are properly classified, described and disclosed in accordance with the applicable Accounting Standards, and
   (f) **Truth and Fairness:** The Financial Statements, on the whole, reflect a true and fair view of the operational results and of the Assets and Liabilities.

1.1.4 Auditor vs Management Responsibility – Scope of Audit

1. **Audit Objective:** The objective of an audit is to enable an Auditor to **express an opinion** on Financial Statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements.

2. **Scope of Audit:** The Term Scope refers to the range or reach of something. Enhancing the degree of confidence by providing reasonable assurance to the intended users of the Financial Statements being the Prime Objective of Audit, requires the following aspects to be included in the scope of audit to enable the auditor to express such an opinion

General Inclusions	General Exclusions
(a) **Coverage of all aspects of entity:** Audit shall be organized adequately to cover all aspects of the entity. (b) **Reliability and sufficiency:** The auditor shall satisfy himself of the reliability and sufficiency of the source information with which financial statements are prepared. He shall make judgment as to the reliability and sufficiency by studying & assessing the accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures. (c) **Proper disclosure of Financial Information:** Whether the relevant financial information is summarized and properly disclosed as per the statutory requirements and applicable financial reporting framework. (d) **Selection and application of accounting policies by the management:** Whether the selected accounting policies are proper and permitted as per the relevant framework and whether period to period applied on a consistent basis.	(a) Perform duties which fall outside the domain of his professional competence (b) Authentication of Documents – genuineness of documents (c) Investigation – The auditor is not an official investigator into the alleged wrongdoings. He does not have any specific legal powers in this regard

Note:

A. Financial Statements are prepared based on Historical Financial Information – meaning – information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

B. Differentiation between audit and investigation is discussed in detail subsequently in this chapter.

C. **Refer Chapter 15** for detailed discussion on the Scope of Audit as per the Standards on Auditing

3. **Management Responsibility:**
   (a) The Management of an enterprise is **primarily responsible** for the preparation of Financial Statements, by establishing an accounting system to identify, measure, record and adequately disclose the Entity's transactions and events.
   (b) Management's responsibilities include maintenance of adequate accounting records and internal controls, selection and application of accounting policies and safeguarding the assets of the enterprise.
   (c) Management's responsibility for Financial Statements is also covered by Sec.134 of the Companies Act, 2013.
   (d) Hence, the audit of the Financial Statements does not relieve Management of its responsibilities.

4. **Auditor's Responsibilities:** While conducting the examination, the auditor shall see that the financial statements is not misleading by ensuring that:
   (a) The Accounts are drawn up with reference to the entries in the Books of Accounts
   (b) The entries in the Books of Accounts are supported by sufficient and appropriate evidence
   (c) None of the entries has been omitted in the process of compilation
   (d) The Information conveyed is clear and unambiguous
   (e) The amounts are properly classified, described and disclosed in conformity with the Financial Reporting Framework
   (f) The statements present a true and fair picture of the operational results and the assets and liabilities.

5. **Nature of examination:** Conventional financial audit is concerned with examination of the transactions to ascertain the true and fair nature of the Financial Statements. The Auditor is thus merely concerned with evaluating the evidence in support of transactions and need not examine the regularity and prudence of various decisions taken by the Management.

6. **Broad Objectives of Audit as per SA 200:** The Broad Objectives of Audit is as follows, –
   (a) Obtaining a reasonable assurance that the financial statements are free from material misstatement due to Fraud or Error
   (b) Gaining such reasonable assurance leads to formation of opinion as to whether the financial statements are prepared, in all material aspects, in accordance with the applicable Financial Reporting Framework
   (c) Reporting on the Financial Statements and Communication of the Audit Findings to the appropriate level of management as required under the Standards on Auditing.

7. **Inference of Audit Report:** The Auditor's opinion is **not** to be taken as an assurance as to – (a) the future viability of an enterprise, or (b) the efficiency or effectiveness with which the Management has conducted the affairs. Thus, generally, it is **not** a part of the Auditor's duty to probe into the propriety of business conduct.

8. **Recent Developments:** However, certain aspects of propriety and financial prudence have been gradually and slowly included in the scope of audit, e.g. reporting requirements u/s 143 of the Companies Act, 2013.

1.1.5 Independence of Auditor

[Also See **Chapter 10** for Specific Provisions in the Companies Act, 2013 w.r.to Independence of Company Auditor]

1. **Requirement:** The definition of the term "Audit" as per SA 200, starts with the basic requirement of Independence *"Audit is an Independent Examination of any Financial information……"*
2. **Basic Principle:** Integrity, Objectivity and Independence as one of the basic principles governing an audit. The Auditor should be straight–forward, 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 both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.
3. **Meaning:** Independence implies that the judgement of a person is not sub–ordinate to the wishes or directions of another person who might have engaged him or to his own self–interest.
4. **Nature:** Independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence, which are imposed by law. For example, the Companies Act has certain provisions, which guarantee the independence of the Auditor.
5. **Visibility:** Independence of the Auditor should not only exist in fact, but should also **appear to so exist** to all reasonable persons. The relationship maintained by the Auditor shall be such that no reasonable man can doubt his objectivity and integrity. There is a collective aspect of independence that is important to the accounting profession as a whole.
6. **Examples to understand Independence:**
   (a) A person requires his sister (a CA in Practice) to audit the accounts of his Proprietary Concern. In this case, there would be no independence for the CA due to the virtue of their relationship.
   (b) A CA auditing the accounts of the company in which he holds huge amount of shares. In this case, due to the fact that his own money is invested in the company (holding shares), his self–interest is involved. Therefore, he may be able to form an independent judgment on the Financial Statements.

   Note: Refer Threats to Independence for detailed discussion on the guiding principles with respect to Threats to Independence and the safeguards to counter such threats.

1.1.6 Effect of Related Services on Auditors' Independence

When an Auditor provides certain related services to the Client, his independence may be impaired / affected. These matters are described below –

1. **TAXATION SERVICES:**
   (c) **Nature of Service:** Many Audit Firms may prepare tax computation for their Client Companies and this should not normally compromise independence.

   (d) **Area of Conflict:**
   - Where Taxation Services are provided to the Company, a conflict of interest could arise in dealing with the tax affairs of the Directors (e.g. if any of the Directors are also Shareholders, they may have preferences as to Dividends or Bonuses, which are not in the best interests of the Company's Tax or Cash Flow Position).
   - There may also be independence issues in relation to tax advisory work. For example, the Audit Firm may have difficulty in giving an independent view on the acceptability of a scheme to the Revenue or GST, if the Firm designed the scheme itself in the first place.

   (e) **Mitigating Conflict:** As a safeguard, a Tax Manager (or Partner) independent of the audit function may be assigned, to deal with Individual Director's Tax Affairs.

2. **ACCOUNTANCY SERVICES:**
   (a) **Nature of Service:** For many audit clients, it is common to provide a range of accountancy services including participation in the preparation of accounting records.
   (b) **Area of Conflict:**
   - An Audit Firm should **not** participate in the preparation of the Company's accounts and accounting records.
   - Further, preparing periodic Management Accounts may draw the Auditor, inadvertently, into performing management functions.

(c) **Mitigating Conflict:** Safeguards include the following –
- The Client accepting responsibility for the records as its own.
- The Auditor not assuming an operational role.
- Conducting appropriate audit tests on records processed / maintained by the Entity.

3. **MANAGEMENT CONSULTANCY:**

(a) **Area of Conflict:** An Auditors' independence may be compromised, if a course of action is recommended to an Audit Client. For example, if the Auditor advises on a new computer system which is then found to be unreliable, the Auditor may be reluctant to report the weaknesses to Management.

(b) **Mitigating Conflict:**
- As a safeguard, Auditors should lay the facts before the Directors, and let then make the decision. It is important that the Auditor is not seen to be acting as part of the Management function.
- Services involving the design & implementation of Financial Information Systems should not be provided by the auditor.

4. **PREPARING CONFIDENTIAL REPORTS:**

(a) **Nature of Service:** Auditors are not prevented from providing Confidential Reports for Bank and other Lenders, provided they have obtained the Client's authority to do so.

(b) **Area of Conflict:** An 'unqualified' Confidential Report recently issued to a Lender may be borne in mind when forming the audit opinion. This may increase pressure not to qualify the audit opinion (to add credibility to the Confidential Report) when qualification is justified.

(c) **Mitigating Conflict:** A Partner other than the Audit Engagement Partner should be responsible for the Confidential Reports. Unless confidentiality is absolutely necessary, the Client should be made aware of the reports to Lenders. The quality of these reports may be enhanced, by consideration of Management's views on the matters included therein.

Note: Sec.144 of the Companies Act 2013, specifically prohibits the Company Auditor from rendering certain services as specified in points 2 & 3 above. **Refer Chapter 10** for details.

1.1.7 Advantages of Independent Audit [Also see **Chapter 10** Company Auditors' Independence.]

Meaning: Independence implies that the judgement of a person is not sub–ordinate to the wishes or directions of another person who might have engaged him or his own self–interest. Independence is a condition of mind and personal character.

The advantages of an independent audit include –

1. **Protection of Interests:** Independent audit safeguards the financial interest of persons who are not associated with the Management of the Firm, whether they are Partners or Shareholders.
2. **Moral Check:** Audit acts as a moral check on the employees from committing defalcations / embezzlement.
3. **Tax Liability:** Audited statements of account are helpful in settling liability for taxes.
4. **Credit Negotiation:** Financiers and Bankers use audited Financial Statements in evaluating the credit worthiness of individuals in negotiating loan. It is also useful for determining the purchase consideration for a business.
5. **Trade Dispute Settlement:** Audited statements are also useful for settling trade disputes for higher wages or bonus as well as claims for damages to property due to fire or some other calamity.
6. **Control over Inefficiency:** Audited Statements prove useful to detect wastages and losses. It shows the different ways by which wastages or losses might be checked, and those that occur due to the absence or inadequacy of internal checks or internal control measures.
7. **Funds–in–Trust:** Audit is a mechanism which ensures that persons acting for others have properly accounted for the amounts collected by them, e.g. Partners, Agents, Liquidators, Receivers, Trustees, etc.
8. **Arbitration:** Audited Financial Statements are useful in settling disputes by arbitration.
9. **Appraisal:** Audit reviews the existence and operations of various controls in the Firm and reports inadequacies, weaknesses, etc. in them. Management can take suitable action based on the reports.
10. **Partnership Cases:** Audited accounts are of great help in the settlement of accounts, valuation of goodwill, etc. at the time of admission or death of a Partner.
11. **Assistance to Government:** Government may require audited and certified statements before it gives assistance or issues a license for a particular trade.

Note: Audit of accounts of a Sole Proprietor is **not compulsory** under any Statute. However, the above benefits would accrue to the Sole Proprietor when he gets his accounts audited voluntarily.

1.1.8 Need for Audit / Pervasiveness of Audit

[Note: Also see previous Para for advantages of Independent Audit.]

1. **Need for Audit:**
   (a) External Agencies who use the Financial Statements, need an assurance that Financial Statements –
   - have been prepared and presented correctly, and
   - reflect the "true and fair" view of the enterprise.

   (b) Hence, an independent examination of the Financial Statements is called for. This gives rise to the need for Auditing.
   (c) So, Auditing is not exactly a luxury, since it assesses the effectiveness of the accounting function also.
2. **Whether Audit is mandatory? –**
   (a) **Mandatory:**
   (A) Companies – Mandatory audit u/s 139 of the Companies Act 2013
   (B) Entities with Income/Turnover exceeding the limits prescribed under the Income Tax Act – Mandatory Tax Audit
   (b) **Voluntary: Refer Point 3** given below
3. **Commercial Organisations:** The accounts of Proprietary Entities, Partnership Firms, Hindu Undivided Families, etc have no legal requirement of audit as such. However, many of such enterprises may have audit, as a matter of their internal rules. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of Grants, Loans, etc, or under Income Tax Act, etc.
4. **Service Organisations:** Service Institutions have internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Further, Educational Institutions, Hospitals, Clubs, Associations, etc. irrespective of any internal rules, get their accounts audited because most of them enjoy Government or Municipal Grants or Income Tax Exemption and generally for this purpose audited accounts are insisted upon.
5. **Non–Profit Organisations:** Audit of Trust Accounts or NPO's is not compulsory as such, however most of the Trust Deeds contain a clause for audit of accounts. Trustees also recognize the advantages of audit in their own interest, since erroneous treatment in the accounts for which they might be personally liable will be pointed out by the Auditor.

1.2 ERRORS AND FRAUDS

1.2.1 Errors vs Frauds – Meaning and Distinction

Particulars	Error	Fraud
1. **Meaning**	Error may be defined as any unintentional mistake or misdescription in the books of account or records by way of – (a) Clerical or arithmetical mistakes in the records and data, (b) Oversight or misinterpretation of facts, or (c) Misapplication of accounting policies.	Fraud is defined as an intentional act by one or more individual among Management, Those Charged with Governance, Employees or Third Parties, involving the use of deception to obtain an unjust or illegal advantage. **[SA–240]**
2. **Intention**	Errors are mistakes made through **ignorance or inadvertence**. An error is generally taken to be innocent and not deliberate.	Fraud is **intentional** error. It involves a wilful misrepresentation, the deliberate concealment of a material fact or the failure to disclose a material fact, for the purpose of inducing another person & putting him at a disadvantage.
3. **Types**	They are classified into – (a) Clerical Errors: Errors of Omission and Errors of Commission, (b) Errors of Principle, (c) Errors of Duplication, and (d) Compensating Errors.	It can occur in any of the following forms – (a) Misappropriation / Embezzlement of Cash, (b) Teeming and Lading, (c) Misappropriation of goods, (d) Forgery of Vouchers, inclusion of "ghost" bills, (e) Services rendered but not accounted for, (f) Manipulation and falsification of accounts, (g) Window–Dressing.
4. **Detection**	Self–revealing errors and other errors can easily be detected by a careful scrutiny of the accounts. For example, failure to record in the cash book amounts paid into or withdrawn from the bank will be revealed by reviewing the Bank Reconciliation Statement.	These can be detected by due care and diligence on the part of the Auditor and by use of proper internal controls checks instituted by the Entity.

1.2.2 Classification of Errors

In his book "Fundamentals of Auditing", **R.K.Mautz** has classified the types of errors into –

Self–Revealing Errors	Non Self–Revealing Errors
The existence of these errors becomes apparent during the course of accounts preparation e.g. if a cheque issued is omitted, it will be revealed during the preparation of Bank Reconciliation Statement. Similarly, certain errors of commission cause difference in the Trial Balance.	These do not reveal themselves during the course of accounts preparation. Their existence can be known only on detailed and specific analysis. **Example:** Compensating Errors, failure to distinguish between Capital and Revenue Expenditure, etc.

Unintentional Errors	Intentional Errors
It is an innocent or non–deliberate mistake due to ignorance or inadvertence.	It refers to the deliberate and purposive mistake, i.e. Fraud. **Example:** Fraudulent Financial Reporting or Misappropriation of assets / goods, etc.

Unconcealed Errors	Concealed Errors
It is similar to unintentional error. The error is ascertained on a basic review of accounts.	It refers to a series of errors committed in order to deliberately hide an earlier mistake. It can be ascertained only after careful scrutiny.

Errors affecting Trial Balance	Errors not affecting Trial Balance
One–sided errors of commission or omission throw out a difference in the Trial Balance.	This may include Compensating Errors, Complete Omission or Errors like mis–statement of Contingent Liabilities, not creating Provision for Depreciation, etc.

1.2.3 Analysis of Errors

	Errors of Commission	Errors of Omission	Errors of Principle	Compensating Errors
Meaning	A transaction is recorded wrongly or incorrectly in the books.	A transaction is not recorded either wholly or partially, in the books of accounts.	A transaction is basically recorded in the books in an incorrect manner.	An Error which is counter balanced by another error(s), so that it is not disclosed by the TB.
Types	(a) **Posting Errors:** wrong account, wrong amount, wrong side, etc. (b) **Casting Errors:** wrong totalling or balancing. (c) **Carry Forward Errors:** carrying forward a wrong amount, wrong side, etc. (d) **Duplication Errors:** i.e. recording the same transaction twice in the book of original entry and also posting it to the ledger.	(a) **Partial Omission:** One aspect of transaction, either debit or credit, is omitted to be recorded. TB will not agree. It arises from posting errors – posting on one–side only and omitting the other side entry. (b) **Total Omission:** Both aspects of a transaction, debit and credit, are omitted to be recorded. TB will still agree. It arises from omission – either in the book of original entry or in the ledger.	(a) **Errors which do not affect Profit:** e.g. Direct Wages posted to Trade Expenses A/c or wrong classification of Assets or Liabilities. (b) **Errors which affect Profit:** e.g. treating rent paid as a debtor instead of 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 error arises 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 ₹ 96,000 lower and cost of asset account ₹ 96,000 higher, profit and asset being thereby shown improperly.
Effect on TB	One–sided Errors cause difference in TB but two–sided errors will not affect it. e.g. Duplication Errors do not affect TB, but a posting error on wrong side will affect it.	Complete Omission will not affect Trial Balance but Partial Omission in posting will show a difference in the Trial Balance.	These errors will not affect the Trial Balance.	These errors will not affect the Trial Balance.

	Errors of Commission	Errors of Omission	Errors of Principle	Compensating Errors
Effect on Profit	Effect of these errors on Profit cannot be generalized. If the errors involve nominal accounts, i.e. Income and Expenditure items, Profits are affected.	Effect of these errors on Profit cannot be generalized. If the errors involve nominal accounts, i.e. Income and Expenditure items, Profits are affected.	Errors that involve Income and Expenditure a/c, e.g. wrong distinction between Capital and Revenue Expenditure will affect Profit.	Compensating Errors, involving Income and Expenditure accounts will affect profit. But if error is in asset and liability accounts only, Profits may not be affected.
Detection	Errors of Commission, which have not been deliberately concealed, can be detected through normal audit procedures, e.g. vouching, analytical review, ledger scrutiny, posting checking, casting checking, carry forward of balances checking, etc.	Partial Omission, if not deliberately concealed, can be detected by regular audit procedures, e.g. vouching, analytical reviews, ledger scrutiny, checking of posting, casting, carry forward of balances, etc. Complete Omission is comparatively difficult to detect.	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.

1.2.4 Forms of Frauds **(Note: Also see SA–240 for types of Frauds)**

Forms of Fraud	Example
1. **Manipulation**, falsification or alteration of records or documents	In a period of rising prices, Sales Contract documents may be ante–dated, to record Sales at price lower than the actual sales prices.
2. **Misappropriation** of Assets / Goods	Cash Sales may not be fully accounted for, the omitted cash may be misappropriated, stock records may be deliberately tampered with, in order to cover up misappropriation.
3. **Suppression or omission** of the effects of transactions	Goods Sold may not be recorded as Sales, but included in Inventories.
4. Recording of **transactions without substance**	Goods delivered on Consignment basis or on Sale on Approval Basis, may be recorded as Sales.
5. Deliberate **misapplication** of accounting policies	Where a Contracting Firm follows the 'Completed Contract' method of accounting, but does not provide for a known loss on incomplete contracts.

1.2.5 Reasons / Circumstances of Errors & Frauds

R K Mautz lists the reasons and circumstances of errors and frauds as under –

Errors	Frauds
1. **Ignorance of employees** about accounting developments, generally accepted accounting principles and good accounting practices in general. 2. **Inappropriate account classification** by employees during reconciliation of subsidiary ledgers with the controlling accounts. 3. **Carelessness** on the part of those involved in the accounting work. 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.	1. A **desire to conceal** the effect of defalcations or shortages of one kind or another. 2. An ever–present desire to **hold taxes** on income to minimum. 3. Intentional effort committed by persons in **position of authority** to – (a) show up or depress the picture depicted by the Financial Statements, or (b) convert the error to a personal benefit.

1.2.6 Management Fraud vs Employee Fraud

	Management Fraud	Employee Fraud
1. **Meaning**	Fraud involving one or more members of Management or Those Charged with Governance, is referred to as Management Fraud.	Fraud involving only employees of the entity is referred to as Employee Fraud.
2. **Examples**	Intentional misapplication of accounting policies, window–dressing, etc.	Mis–appropriation of assets, defalcation of cash, theft of stocks, etc.

Note: In either case, there may be collusion with third parties outside the entity.

1.2.7 A. Examples of Frauds in Accounts

Frauds range from efforts to conceal one's ignorance or incompetence or petty thefts of cash or merchandise to things such as major defalcations and untruthful Financial Statements issued to outsiders. Some examples are –

1. "Forceful" tallying of Trial Balance by Ledger–Keepers,
2. Inclusion of forged vouchers by petty cashiers to cover their thefts,
3. Putting wrong totals in various columns to tally the cross–totalling,
4. Over–stating goods issued to cover mis–appropriation of goods,
5. Suppression of receipts through Teeming and Lading,
6. Window Dressing – e.g. improper classification of asset / liability items to improve the current position in Balance Sheet issued for loan purposes.

1.2.7 B. Frauds by Ledger Keepers

A. **Frauds in Creditors / Purchase Ledger:**

1. **Double Credit:** Crediting the Suppliers' Account with a "fictitious" invoice (where goods have not been received) or duplicate copy of an invoice, and misappropriating the payment made against such invoice.
2. **Omitting Debits:** Suppressing or omitting a "Credit Note" issued by the Supplier in respect of Purchase Return, or in respect of any other discount / price / quality / quantity adjustment, and misappropriating the payment made towards such amount.
3. **Wrong Name:** Crediting an amount due to a Supplier not in his name, but under a fictitious name, and misappropriating the amount paid against such credit balance.

B. **Frauds in Debtors / Sales Ledger:**

1. **Teeming and Lading:** Misappropriating receipt from one customer, and to prevent its detection, subsequent receipts from a different customer is credited to the first party's account. This cycle of wrong party's credit continues such that no party's account is outstanding for a long period, and Management's attention will not be generally attracted to such overdue account.
2. **Unauthorised Credits:** Adjusting unauthorized or fictitious rebates, allowances, discounts, etc. in customer' accounts and misappropriating amount paid by them.
3. **Write Offs:** Writing off as Bad Debts, balances for which cash has already been received & misappropriated.

C. **Frauds in Nominal Ledger:**

1. Allocating an item of expense wrongly, i.e. capital expenditure charged as revenue, or vice–versa,
2. Understating or overstating the value of stocks, prepaid expenses, other liabilities.
3. Booking of fictitious or non–existent expenses as genuine business expenditure, wrongfully charging personal expenses as revenue expenditure, etc.

1.2.7 C. Defalcation of Cash

Misappropriation / Embezzlement / Defalcation of Cash is generally perpetrated in the following ways –

1. By inflating Cash Payments,
2. By suppressing Cash Receipts, and
3. By casting wrong totals in the Cash Book.

Examples of Inflating Cash Payments	Examples of Suppressing Cash Receipts
1. Making payments against fictitious vouchers. 2. Making payments against vouchers, the amounts whereof have been inflated. 3. Manipulating totals of wage rolls either by including therein names of dummy workers, or salary paid to apprentices whose tenure of services expired 4. Casting larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals agree.	1. Teeming and Lading: **See explanation in previous Para.** 2. Adjusting unauthorized or fictitious rebates, allowances, discounts, etc. in customer' accounts and misappropriating amount paid by them. 3. Writing off as Bad Debts, balances for which cash has already been received and misappropriated. 4. Not accounting for Cash Sales fully. 5. Not accounting for Miscellaneous Receipts, e.g. Sale of Scrap, Rent from quarters allotted to employees, etc. 6. Writing down asset values, selling them subsequently and misappropriating the proceeds.

1.2.7 D. Window–Dressing

1. **Meaning:** "Window–Dressing" stands for mis–presentation of accounts with a view to present a better picture of the state of financial affairs than its actual. [**Note:** Sometimes this may be referred as **Fraudulent Financial Reporting**].
2. **Difficult to Detect:** The detection of such manipulation of accounts is difficult because –
   (a) Generally persons in higher management cadre are associated with this manipulation, and
   (b) It is done in a methodical manner.
3. **Methods:** Window–Dressing can be done in various ways. Some illustrations are –
   (a) Selecting inappropriate accounting principles, e.g. methods of depreciation,
   (b) Capitalising revenue expenses or vice–versa,
   (c) Grouping items in a different manner, e.g. Sundry Creditors shown as Unsecured Loans than Current Liabilities, to boost the Current Ratio,
   (d) Treating certain items differently on the basis of legal interpretations, etc.
4. **Objects / Purposes of Window–Dressing:**
   (a) To show more profits and to give Managerial Personnel more remuneration where remuneration is linked with profit.
   (b) To attract / obtain more loans, credits, etc. from Bankers and Financial Institutions.
   (c) To avoid incidence of income–tax or other taxes.
   (d) To declare dividends when there are insufficient profits.
   (e) To withhold declaration of dividends even when there is adequate profit.
   (f) To attract potential investors for subscribing to public issues.

1.2.8 Responsibility of Auditor w.r.t. Errors & Frauds

Refer **Significant Case Decisions** given in the end of the Chapter, covering Auditors' Responsibility in this regard.

1. **Evaluation of Auditor's Performance:** The Auditor's performance is judicially reviewed by applying the following tests –
   (a) Has he exercised reasonable care and skill in carrying out his work?
   (b) Could the errors and frauds have been detected in ordinary course of checking without aid of any special efforts?
   (c) Has the Management taken all reasonable care to prevent errors and frauds?
   (d) Did the Auditor have any reason to suspect the existence of the errors and frauds? and
   (e) Were the errors or frauds so concealed and deep laid that the same might not have been detected by the application of normal audit procedures?
2. **Responsibility of Auditor:**
   (a) If a fraud has been detected after the completion of the Statutory Audit, it cannot by itself mean that the Auditor did not perform his duty properly.
   (b) If the Auditor can prove with the help of his working papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for non–detection of clearly concealed frauds and errors.
   (c) If however, the same cannot be proved and he is found negligent in the discharge of his audit function, he would be held responsible / liable.
3. **Duties of an Auditor based on Legal Decisions:** Considering the Legal Decisions of various Courts, the duties and responsibilities of an Auditor are summarized as follows – [Also see **Chapter 10 Duties under Companies Act**]
   (a) **To verify that the Financial Statements are drawn as per books of the Entity:** The Auditor is not responsible for failure to disclose the affairs of the Company, kept out of the books and concealed from him which could not be known in the ordinary course of exercise of reasonable care and diligence. However, it is his duty to check the books for finding out that the position, as shown by the books of account, is true and substantially correct.
   (b) **To verify that the Financial Statements exhibit a true and fair state of affairs of the Entity:** The duty of the Auditor is not limited to mere verification of the arithmetical accuracy of the Financial Statements. He must find out that these are substantially correct, having regard to accounting principles, provisions in the Articles and the Statute governing the business, wherever applicable.
   (c) **To confirm that the Management has not exceeded** the financial administrative powers vested in it by the Articles or by any specific resolution of the shareholders recorded at a general meeting.

(d) **To investigate matters in regard to which his suspicion is aroused as to the result of a certain action on the part of the servants of the Company:** Auditor is, however, not required to start an Audit with a suspicion or to prove in the manner of trying to detect a fraud or an irregularity unless some information has reached him which excites his suspicion or should arouse suspicion in a professional man of reasonable competence. This is because, his duty is verification and not primarily detection of fraud.

(e) **To perform his duties by exercising reasonable skill and care:** For the verification of matters which are not capable of direct verification. The Auditor can rely on what he believes to be honest statements of the Management. He must, however, review the verification of Assets by the Company and not rely merely on the statement made by the persons appointed by the Company.

1.3 PRINCIPLES & SCOPE OF AUDIT

1.3.1 Basic Principles governing an audit

The basic principles which govern the Auditor's professional responsibilities and which should be complied with whenever an audit is carried out are –

1. **Integrity, Objectivity and Independence:**
   (a) The Auditor should be straight–forward, honest and sincere in his approach to his professional work.
   (b) He should be fair, and must not allow prejudice or bias to override his objectivity.
   (c) He should maintain an impartial attitude, and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

2. **Confidentiality:**
   (a) The Auditor should respect the confidentiality of information acquired in the course of his work.
   (b) He should not disclose any such information to a third party, without specific authority or, unless there is a legal or professional duty to disclose.

3. **Skills and Competence:**
   (a) The audit should be performed and the report prepared with due professional care, by persons who have adequate training, experience and competence.
   (b) The requisite qualities can be acquired through a combination of –
   - General education,
   - Technical knowledge obtained through study and formal courses concluded by a qualifying examination recognised for this purpose,
   - Practical experience under proper supervision. and,
   - Continuing awareness of developments, relevant regulations and statutory requirements.

4. **Work Performed by Others:** **[Also see SA–620 on Using the Work of Auditors' Expert.]**
   (a) The Auditor can delegate work to assistants or use work performed by other Auditors and Experts. However, he will continue to be responsible, for forming and expressing his opinion on the financial information.
   (b) The Auditor is entitled to rely on work performed by others, provided –
   - He exercises adequate skills and care, and,
   - He is not aware of any reason to believe that he should not have so relied.

   (c) The Auditor should carefully direct, supervise and review work delegated to assistants.
   (d) He should obtain reasonable assurance that work performed by other Auditors or Experts is adequate for his 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:**
   (a) 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 the Client's business.
   (b) They should be further developed and revised as necessary, during the course of audit.

(c) Plans should be made to cover, among other things, the following –
- Acquiring knowledge of the Client's accounting system, policies and internal control procedures,
- Establishing the expected degree of reliance to be placed on internal control,
- Determining and programming the nature, timing and extent of audit procedures to be performed, and
- Co–ordinating the work to be performed.

7. **Audit Evidence:**
(a) Sufficient and Appropriate audit evidence should be obtained, by performance of Risk Assessment Procedures, Compliance Procedures and Substantive procedures.
(b) Audit Evidence enables the Auditor to draw a reasonable conclusion therefrom on which he has to base his opinion on the financial information.
(c) Compliance Procedures means the tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.
(d) Substantive Procedures means the procedures designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. They include – (i) tests of details of transactions and balances, and (ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

8. **Accounting System and Internal Control:**
(a) Internal Controls contribute to the audit assurance that the accounting system is adequate and that all the accounting information has been duly recorded.
(b) The Auditor should gain an understanding of the accounting system and related internal controls.
(c) 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:**
(a) The Auditor should review and assess the conclusions drawn, from the audit evidence obtained.
(b) The Auditor should express his opinion on the financial information based on – (i) his knowledge of business of the entity, and (ii) the conclusions drawn above.
(c) This review and assessment involves forming an overall conclusion as to whether –
- the financial information has been prepared using acceptable accounting policies which have been consistently applied,
- the financial information complies with relevant regulations and statutory requirements,
- there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

(d) The Audit Report should contain a clear written expression of opinion on the financial information.
(e) The Report should comply with legal requirements, wherever applicable.
(f) When a Qualified Opinion, Adverse Opinion or a Disclaimer of Opinion is to be given or reservation of opinion on any matter is to be made, the Audit Report should state the reasons thereof.

1.3.2 Principal aspects to be covered in an Audit

The principal aspects to be covered in an audit are – [Also See Reporting Duties under Companies Act, **Chapter 10**]

1. **Internal Control System:**
(a) Examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.
(b) Tests and enquiries to ascertain whether the system is in actual operation so that the Auditor can form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

2. **System Review:** Review of the systems and procedures to find out whether they are adequate and comprehensive, and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

3. **Arithmetical Accuracy:** Checking of arithmetical accuracy of the books of account.

4. **Vouching:** Verification of the authenticity and validity of transactions entered, by making an examination of the entries in the books of account, with the relevant supporting documents.

5. **Accounting Principles:**
   (a) Ascertaining that a proper distinction has been made between items of capital and revenue nature, and
   (b) Ensuring that the amounts of various items of income and expenditure adjusted in the accounts correspond to the accounting period, i.e. adjustment for accrued & prepaid expenses, etc.
6. **Books and Statements:** Comparison of the Balance Sheet and Profit & Loss Account or other Statements with the underlying records in order to see that they are in accordance therewith.
7. **Assets:** Verification of the title, existence and value of the Assets appearing in the Balance Sheet.
8. **Liabilities:** Verification of the Liabilities stated in the Balance Sheet.
9. **True and Fair View:** Checking of the results shown by the Financial Statements and see whether the results shown are true and fair.
10. **Statutory Compliance:** Where the audit is of a Corporate Body, ensuring that the statutory requirements have been complied with.
11. **Report:** Reporting to the appropriate person / body whether the statements of accounts examined actually reveal a true and fair view of the state of affairs, profit or loss, and cash flow position.

1.3.3 Phases of Audit Work

The audit objective (i.e. expression of opinion) can be achieved through the following phases of audit work –

Phase	Procedure
1. **Review of Internal Control**	A critical review of the system of book keeping, accounting records, work processes and internal check existing within the Entity.
2. **Enquiries and Tests**	Making enquiries and tests as to the reliability of records as a basis for preparation of accounts.
3. **Audit Processes**	Performing audit procedures and techniques like vouching, verification, examination in depth, analytical reviews, confirmations, etc. to obtain evidence and audit assurance.
4. **Financial Statements Review**	Review of the form and content of Financial Statements to ensure compliance with legal requirements and also disclosure of the "true and fair" view of the affairs of the Enterprise.

1.3.4 Principles vs Techniques of Auditing

Particulars	Principles of Auditing	Techniques of Auditing
1. **Meaning**	It refers to the fundamental considerations that sustain the function of auditing and direct its activities.	It refers to the methods and means adopted by the Auditor for collection and evaluation of audit evidence in different auditing situations.
2. **Examples**	(a) Integrity, Objectivity & Independence, (b) Confidentiality, (c) Skills and Competence, (d) Work performed by others, (e) Documentation, (f) Planning, (g) Audit Evidence, (h) Accounting System & Internal Control, (i) Audit Conclusions and Reporting.	Some examples are – (a) Physical Inspection (of Fixed Assets), (b) Confirmation (of Debtors Balances), (c) Inquiry (on Accounting Systems), (d) Calculation of Ratios (GP Ratio, NP Ratio), etc
3. **Variability based on Nature**	The principles are not liable to change frequently.	Audit Techniques may vary according to the nature of propositions to be tested.
4. **Effect of Time**	They do not vary with time.	The techniques to be adopted vary with the time / period of auditing.
5. **Variability based on Auditee**	Principles of Auditing remain the same, irrespective of the nature of the Firm.	They may vary from Firm to Firm depending upon the nature of business, number of transactions, etc.

1.3.5 Qualities of Auditors

Some illustrative qualities of Auditors can be classified into –

Knowledge – based Qualities	Personal Qualities
The Auditor should have sufficient knowledge of – 1. General principles of law – of Contracts, Partnerships, etc. 2. Specific Statutes and provisions applicable, e.g. Companies Act, Co–operative Societies Act, etc. 3. Taxation Laws – Direct and Indirect Taxes. 4. Client's nature of business and its peculiar features. 5. General Economic Trends. 6. Accountancy, its principles, techniques, Accounting Standards, etc. 7. Auditing – Standards, Procedures, Techniques & Principles.	1. Tact, 2. Caution, 3. Firmness, 4. Good Temper, 5. Integrity, Objectivity & Independence, 6. Discretion, 7. Judgement, 8. Patience, 9. Clear headedness and Commonsense, 10. Reliability and Trust.

1.3.6 Relationship of Auditing with Other Disciplines

The relationship of Auditing with other disciplines is highlighted as under –

Discipline	Relationship
1. **Accounting**	Auditing process reviews the Financial Statements, which are the result of the overall accounting process. The Auditor should have a thorough and sound knowledge of Accounting Standards and Generally Accepted Accounting Principles for reviewing the Financial Statements.
2. **Behavioural Science**	During the course of his work, the Auditor is required to obtain information and explanations from the Client's staff. He has to interact with the organisation's staff in analysing the financial figures. Hence. the Auditor should have the knack of getting along with people, and obtain relevant information to meet his audit needs.
3. **Business Functions**	Auditing deals with the financial results of operational affairs of an enterprise. The operational functions, i.e. Finance, Production, Cost Systems, Marketing, Personnel, Purchase, Logistics and other general areas of business management are inter–related and have an impact on the accounting process.
4. **Economics**	Accounting is concerned with the accumulation and presentation of data relating to economic activity. Auditing reviews the same from the micro–economic viewpoint. Also the Auditor also takes into account, the general economic environment affecting the business, during the course of his work.
5. **Information Systems/ Data Processing**	Clients carry out their financial accounting activities with the help of computers resulting in a computerized data processing environment. To keep pace with technological developments, Computer–Aided Audit Techniques are adopted. Auditing in an automated environment and data Processing is a developing discipline in itself.
6. **Financial Management**	The Auditor should have a good knowledge of financial techniques such as Working Capital Management, Funds Flow, Ratio Analysis, Capital Budgeting, etc. This will help him provide value added services to the Client rather than traditional ticking and reporting work.
7. **Language**	The knowledge of language is considered essential in auditing field, as the Auditor is required to communicate, both in writing as well as orally, in day–to–day work.
8. **Law**	• Auditing involves examination of transactions from the viewpoint of whether or not they are in tune with the legal provisions. [See **SA–250** for Auditors' Duties in Considering Law.] • The Auditor should have good background in business laws affecting the entity, the law of Contracts, Negotiable Instruments & Taxation Laws.
9. **Logic**	The Auditing Discipline itself is a logical construct. All audit processes and techniques focus on audit evidence evaluation and verifying assertions, which are bound by the rules of logic.
10. **Mathematics**	As the Auditor deals with financial figures, mathematics plays an important role in audit work. Also, the Auditor arrives at meaningful conclusions through analytical reviews or ratio analysis, for which the knowledge of mathematics is essential.
11. **Statistics**	Due to time, cost and other limitations, test check and sample check procedures are considered generally accepted auditing procedures. Knowledge of probability and statistical theory will help in arriving at meaningful audit conclusions.

1.4 TYPES OF AUDIT

1.4.1 Interim Audit

1. **Meaning:** An audit that is taken up between two annual audits is called an Interim Audit.
2. **Advantages:**
   (a) **Immediate detection of errors and frauds:** Errors and frauds, if any, are easily detected, enabling the Management to take timely remedial actions and exercise strict control over accounts.
   (b) **Acts as Deterrent:** The frequent attendance by the Audit Staff deters persons from committing a fraud.
   (c) **Upto date accounts:** The accounting staff of Client is motivated to keep the books of account upto date.
   (d) **Quick completion of Final Audit:** The final audit can be completed in a short span of time.
   (e) **Interim Dividend:** It helps the Company to publish Interim Financial Statements, and for declaration of interim dividend, if any.
3. **Disadvantages:**
   (a) **Loose ends:** Since work is carried out in several instalments, the Audit Staff may fail to keep track of things, which they had not checked on their last or an earlier visit. As a result, some of the transactions may escape audit scrutiny.
   (b) **Tampering:** The Client's staff may alter the entries in the books of account, after checking thereof.
   (c) **Uneconomic:** Interim audit is uneconomical for small sized concerns as a great deal of time and effort would be wasted each time in preparing for the audit.
   (d) **Missing links:** Continuity in work may be lost, particularly when work is executed by many persons at different points of time.

1.4.2 Continuous Audit

1. **Meaning:** When the Auditor's Staff is engaged continuously in checking the accounts of the Client throughout the whole year, or when the Staff attends audit work at intervals (fixed or otherwise), during the course of the financial period, it is called a **Continuous Audit**.
2. **Advantages:**
   (a) **Early detection of errors and frauds:** Management can exercise strict control over the accounts, in as much as it is able to check immediately, the causes of any errors or frauds uncovered by such an audit.
   (b) **Acts as Deterrent:** Frequent attendance of the Audit Staff deters persons from committing fraud.
   (c) **Upto date accounts:** Accounting Staff of the Client is motivated to keep the books of account upto date.
   (d) **Early Final Audit:** The final audit can be completed in time.
   (e) **Knowledge of Clients' affairs:** The Auditor can obtain a more detailed knowledge of the Client's affairs, which enables him to discharge his duties more efficiently.
   (f) **Detailed Coverage:** All aspects of verification are carried out in detail, when compared to final audit where test checks may be resorted to.
   (g) **Staff Planning:** Work scheduling can be done effectively. Staff can be sent regularly by proper planning.
   (h) **Interim Reporting:** Interim Financial Statements can be prepared easily and in a timely manner.
3. **Disadvantages:**
   (a) **Loose ends:** Since work is carried out in several instalments, the Audit Staff may fail to keep track of things, which they had not checked on their last or an earlier visit. As a result some of the transactions may escape audit scrutiny.
   (b) **Tampering:** The Client's staff may alter entries in the books of account, after checking thereof.
   (c) **Uneconomic:** This is uneconomical for small sized concerns as a great deal of time and effort would be wasted each time in preparing for the audit.
   (d) **Interruption of work:** Presence of audit staff at regular intervals may affect the regular work–flow of the Client.
   (e) **Missing Links:** Continuity in work may be lost particularly when work is executed by many persons at different points of time.
   (f) **Boredom:** Routine checking on a continuous basis may make the audit work as mechanical.
   (g) **Time consuming:** Since all transactions are verified, continuous audit will be time–consuming.
   (h) **No guarantee for fraud detection:** Complete verification of all transactions in detail, does not guarantee detection of all errors and frauds. Some material mis–statements may still exist.

4. **Overcoming Disadvantages:** The disadvantages of a continuous audit can be overcome by taking the following precautions –
   (a) **Stage–wise completion:** Audit work should be completed upto a definite stage during the course of each visit. This will eliminate the possibility of loose ends / duplication, etc.
   (b) **Documentation:** Important balances should be noted down at the end of each visit and the same should be compared during the next visit.
   (c) **Surprise Element in visit:** The visits should be at irregular intervals of time so as to catch the Client's staff off–guard, as they would not know the exact dates of the proposed visit.
   (d) **Checking of Nominal Accounts:** Nominal Accounts should be checked only at the time of final closing, and not at an earlier time.
   (e) **Special auditing marks:** The Client's Staff should be instructed not to alter or correct audited figures. The Auditor should also device special form of ticks and place the same against altered figures. The purpose or significance of such special marks should not be disclosed to the Client's staff.

1.4.3 Concurrent Audit

1. **Meaning:** Concurrent Audit is a comprehensive, continuous and systematic examination of all transactions of an Entity, by a person other than those involved in the operations, to ensure accuracy, authenticity and due compliance with the internal systems, procedures and guidelines.
2. **Advantages:**
   (a) Concurrent Audit aims to examine transactions almost instantaneously as soon as the transaction occurs, leading to shortening of the time interval between a transaction and its independent examination.
   (b) It helps in detecting deviations from and drawbacks of the laid down procedures and their working. Remedial action can be implemented immediately.
   (c) The emphasis is on substantive checking of key areas rather test checking of an area.
   (d) It minimises the occurrence of serious errors or fraudulent manipulation, and also minimises the time lag between occurrence thereof and their detection and consequent remedial measures.
3. **Inference:** Hence, Concurrent Audit is a management process tool towards the establishment of sound internal functions and effective control systems.

1.4.4 Annual Audit

1. **Meaning:** A Final or Annual Audit is one, which commences after the books have been closed at the end of the accounting period and thereafter is carried on continuously until completed.
2. **Advantages:**
   (a) **Completed Accounts:** There is no possibility of tampering with accounts since verification starts only after books are closed.
   (b) **Smooth audit:** There is no interruption with regular workflow.
   (c) **Cost effective:** Use of statistical sampling techniques / test checking, leads to time and cost reduction.
   (d) **Continuity of work:** All work can be completed in one session. Compliance with audit programme ensures continuity and avoids missing links.
3. **Disadvantages:**
   (a) **Time delay:** Since work commences only at the fag end or after the financial year, there is a delay in presentation of final accounts.
   (b) **Belated analysis:** Existence of errors and frauds are known belatedly. Hence, responsibility cannot be fixed for defalcation / misappropriation, if any.
   (c) **Sample Testing:** Detailed checking is not possible. There is higher risk of frauds and errors particularly if the internal control is ineffective.
   (d) **Poor Planning:** Planning of various Clients' audit becomes tedious, particularly at the beginning of next financial year.

1.4.5 Balance Sheet Audit

1. **Meaning:** Balance Sheet Audit consists of complete verification of all items contained in the Balance Sheet and Profit & Loss Account. The Auditor reviews the Balance Sheet and works back to the books of original entry and other evidences.
2. **Analysis:** The Auditor performs analytical review of the items in the Financial Statements and investigates –
   (a) material deviations from budgeted amounts,
   (b) items of unusual and non–recurring nature, and
   (c) items requiring statutory disclosure.
3. **Reliance on Internal Control:** It is assumed that there is a reliable system of internal check and internal audit. Much of the vouching, casting and posting and other routine audit is eliminated, considering the soundness of Internal Control System. Where internal controls are considered weak, the Auditor might prefer more elaborate testing procedures to obtain audit assurance. The same extent of checking may not be required for other areas.
4. **Need:** The need for Balance Sheet Audit by departing away from routine "ticking" of vouchers and "post and vouch" audit arises due to –
   (a) Development and consolidation of industries, into larger economic units,
   (b) Adoption of very elaborate and formal control systems by organizations,
   (c) Growth in size of business,
   (d) Increase in number of transactions of homogeneous nature,
   (e) Computerisation and use of Information System controls in financial data processing.
5. **Audit Approach:** The Auditor's approach to the Balance Sheet Audit will be as under –
   (a) Evaluation of the Client's Internal Control System to ensure its efficacy,
   (b) Identification of areas where sample testing is required,
   (c) Performance of compliance procedures and substantive procedures in selected areas,
   (d) Verification of the Financial Statements with the books of account,
   (e) Scrutiny of Financial Statements as regards Incomes, Expenditure, Assets and Liabilities,
   (f) Verification of Assets and Liabilities,
   (g) Ensuring compliance with legal requirements, wherever applicable,
   (h) Performing overall tests and analytical reviews, and
   (i) Obtaining overall audit assurance and expressing an opinion on the Financial Statements.
6. **Conclusion:** Thus, the concept of Balance Sheet Audit has developed along with the development of formal Internal Control Systems.

1.5 DISTINCTIONS

1.5.1 Auditing vs Accounting

Particulars	Auditing	Accounting
Meaning	An audit is independent examination of financial information of any Entity, when such an examination is conducted with a view to expressing an opinion thereon.	Accounting is the art of recording, classifying and summarizing financial information, transactions and events, and preparation of reports thereon.
Objective	Verification of underlying vouchers and records and obtaining evidence on the true and fair view presented by Financial Statements.	Recording of transactions from underlying vouchers and preparation of Financial Statements.
Responsibility	Auditor is appointed by the owners of the Entity. His responsibility is to review the accounting system, Financial Statements and express his opinion thereon.	It is the Management's primary responsibility to maintain and implement an effective accounting system.
Deals with	Independent examination of financial information prepared by the Management of an Entity.	Measurement and communication of information to Shareholders and other users of Financial Statements.
Aspect of transaction	Auditing reviews the efficacy of recording financial information.	Accounting involves recording aspects of financial information.

1.5.2 Auditing vs Investigation

Kohler's Definition of Investigation: "An examination of books and records preliminary to financing or for any other specified purpose, sometimes differing in scope from the ordinary audit".

Particulars	Auditing	Investigation
Meaning	An audit is independent examination of financial information of any Entity, when such an examination is conducted with a view to expressing an opinion thereon.	Investigation implies systematic, critical and special examination of the records of a business for a specific purpose.
Purpose	To report whether the Financial Statements present a True and Fair view of the financial position and performance.	To evaluate the state of affairs or to establish certain facts.
Mandatory Nature	Mandatory for Companies. For others, it is voluntary.	Voluntary.
Appointing Agency	Owners / Shareholders of the Enterprise.	Owners / Management /even third parties may appoint the Investigator.
Protection of Interests	Work is carried out on behalf of the Owners, even if the power of appointment is delegated to say, Board of Directors.	Work is carried out from the viewpoint of the appointing agency.
Conducted by	A Chartered Accountant within the meaning of the Chartered Accountants Act, 1949.	Any person, who need not necessarily be a Chartered Accountant.
Scope and Coverage	General – when compared to investigation –seeks to form an opinion on the Financial Statements.	Specific – seeks to answer only those questions laid down in the engagement letter.
Period covered	Generally a period of one financial year.	Not necessarily restricted to a financial year. It can extend for a period consisting of a number of years.
Pre–conceptions	Audit is not based on suspicion, unless circumstances exist to arouse suspicion of the Auditor.	Its essence lies in going into the matter with some pre–conceived notion suited to the objective.
Evidence	Much of audit evidence is persuasive rather than conclusive.	Seeks conclusive and corroborative evidence.
Financial Aspects	Generally covers financial aspects only. Non–financial aspects, to the extent they are closely related to financial information are studied.	Covers both financial and non–financial aspects.
Extent of checking	Test checks may be applied, depending on the degree of reliance on internal control.	Detailed, exhaustive and thorough checking is called for.
Form of reporting	The matters to be covered in the audit report are sometimes prescribed by law.	There is no statutory form of investigation report.

1.5.3 Financial Audit vs Cost Audit

Particulars	Financial Audit	Cost Audit
Applicability	Mandatory to all enterprises governed by Statute.	Applicable only to those Companies specified under Law.
Aspect of verification	True and Fair view of Financial Statements.	Propriety and efficiency of transactions having an effect on cost of goods produced.
Coverage	Covers all items forming part of the Financial Statements.	Primarily covers the cost aspects of the Enterprise.

1.5.4 Financial Audit vs Management Audit

Particulars	Financial Audit	Management Audit
1. Meaning	Examination of Financial Statements to express an opinion thereon.	Review of the decisions and actions of Management to analyse performance.
2. Propriety	Generally propriety aspect is not considered in detail.	Propriety and efficiency of decisions and managerial actions are studied.
3. Coverage	Restricted to items forming part of the Financial Statements.	Covers all aspects like organisational objectives, policies, procedures, structure, controls and systems.

1.5.5 Statutory Audit vs Voluntary Audit

Particulars	Statutory / Mandatory Audit	Voluntary / Independent Audit
Meaning	Audit is prescribed by law, i.e. Governing Statute or by the regulations governing the enterprise.	Audit is purely optional and at the discretion of the governing body.
Examples of enterprises	Companies, Co–Operative Societies, etc. **[See Note below]**	Individuals, Private Trusts, Partnership Firms etc. which are not governed by any audit provisions of the Income Tax Act or GST Act.
Advantages	Statutory Compliance is the main audit advantage. All advantages of audit accrue to the enterprise.	The advantages of independent audit are discussed in **Para 1.1.7 above.**
Quali–fications	Only a person possessing the prescribed qualifications shall conduct the audit.	Qualifications for conducting audit are not prescribed by law.
Scope	It is defined by law.	It is defined by the Letter of Engagement between the Auditor and Client. **[SA–210]**
Auditors' rights / duties	Where scope is defined by law, it cannot be restricted by the appointing authority.	It is defined by the Client, and can be for partial audit also.
Format of Report	The matters to be covered in the Auditors' Report are generally defined by law.	The aspects to be covered by the Report are defined by the scope of work.

Note: Examples of Statutory Audit

Enterprise	Governing Statute
Companies	Companies Act, 2013
Banking Companies	Banking Regulation Act, 1949 and Companies Act, 2013
Electricity Companies	Indian Electricity Act, 1910 and Companies Act, 2013
Insurance Companies	Insurance Act and Companies Act, 2013
Co–operative Societies	Co–operative Societies Act, 1912
Public Charitable Trusts	Religious and Endowment Acts
Corporations	Statute by which the Corporation is created, e.g. IDBI Act, LIC,etc.

1.5.6 Internal Audit vs External Statutory Audit

Particulars	Internal Audit	External Statutory Audit
Appointing Authority	Management of the enterprise.	Owners of the Enterprise, e.g. Shareholders of a Company.
Scope	Defined by the appointing authority.	Defined by law.
Approach	To ensure – (a) adherence to Management policies, (b) safeguard of assets, and (c) completeness & accuracy of accounting records.	To collect sufficient and reliable audit evidence as to the "true and fair" view presented by Financial Statements.
Independence	Considered less independent than the Statutory Auditor. Even an Employee of the Enterprise can also be the Internal Auditor.	Wholly independent of the Enterprise and the appointing authority.
Responsibility	To report to Management on the compliance of procedures with – (a) accounting, (b) financial, and (c) administrative controls.	To express an audit opinion on the true and fair view of the Financial Statements.
Submission of Report	To the Management.	To the Owners / Shareholders.
Format of Report	No format is prescribed. It depends on the nature of work, coverage & audit observations.	The aspects to be covered in the report are prescribed by law.

1.5.7 Interim Audit vs Concurrent Audit

Particulars	Interim Audit	Concurrent Audit
Meaning	An audit that is taken up between two annual audits is called an Interim Audit.	It implies verification of transactions of a year on a continuous basis, at various points of time during the same year.
Time period	A specific date, as per the Client's requirement is taken into account, e.g. 30th September, 31st December, etc.	The period of verification is primarily determined by the Auditor, e.g. verification of transactions for a month / fortnight / week, etc.
Trial Balance	A Trial Balance is drawn and verified with a view to prepare Financial Statements.	A Trial Balance may be drawn with a view to establish arithmetical accuracy of accounting process, verification of transactions, etc.
Financial Statements	Financial Statements are prepared and authenticated for interim audit period.	Financial Statements are not prepared for the period of Concurrent Audit.
Asset Verification	Assets and Liabilities are verified for interim Balance Sheet purposes.	Assets and Liabilities are verified only at the time of finalisation at year–end.

1.6 Code of Ethics

1.6.1 Code of Ethics – Basics

1. **Meaning of Ethics:** The term "Ethics" means moral principles which govern a person's behaviour or the conducting of an activity. It is the branch of knowledge that deals with moral principles, whereas "Professional Ethics" consist of personal, organizational and corporate standards of behaviour expected for professionals.

2. **Responsibility of a CA:**
   (a) Chartered Accountants as professionals are engaged in building trust to vast variety of users, whether Shareholders, Government, Banks, Investors, Employees or others, which imposes a public interest responsibility on their profession. **Code of Ethics issued by ICAI, establishes ethical requirements for Professional Accountants.**
   (b) A Chartered Accountant, either in practice or in service, has to abide by these ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their jobs. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants.

3. **Necessity of this Code:**
   (a) It is nothing but the laws or rules of acceptable behaviour. The whole foundation of CA profession, is its credibility. The sole purpose of Code of Ethics is to **ensure and uphold this credibility**. The main ingredient of our profession is independence. An auditor needs to be independent while carrying out his audit.
   (b) Our Institute's Motto – **'Ya Esha Supteshu Jagrati'** is adopted from Kathopanishad and it denotes 'Eternal Vigilance' – awakening when the world is asleep.
   (c) Code of Ethics seeks to protect the interests of the profession as a whole. It is a shield that enables us to command respect.

1.6.2 Applicability

A **Professional Accountant's** responsibility is not exclusively to satisfy the needs of an **individual client or employer** but also acting in the public interest. A professional accountant should **observe and comply** with the ethical requirements of this Code. This Code of Ethics issued by ICAI is in **3 parts**.

Parts	Details
Part A	**Part A** establishes the fundamental principles of professional ethics for Professional Accountants and provides a conceptual framework for applying those principles. (a) The conceptual framework provides guidance on fundamental ethical principles. (b) Professional accountants are required to apply this conceptual framework to identify **threats to compliance** with the fundamental principles, to evaluate their significance and, if such threats are other than clearly insignificant to **apply safeguards** to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.