Chapter 1: Nature of Auditing

STATISTICS OF THE CHAPTER
- Tentative Weightage of Chapter: 5 to 10 Marks

IMPORTANCE OF THE CHAPTER
This chapter lays the foundation of audit for the students.

SAs COVERED
SA 200, SA 240

COVERAGE OF THE CHAPTER
1. Meaning of Audit and its objectives
2. Auditor and his qualities
3. Errors and Frauds: Types of Error and Frauds
4. Basic Principles, Scope and Types of Audit
5. Limitations of Audit
6. Investigation and how it is different from Audit
7. Accounting and how it is different from Audit
8. Relation of audit with different fields

Q1. ☑ What is auditing?

As per General Guidelines on Internal Auditing issued by ICAI, Auditing is defined as,
- a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise
- for a stated purpose.
- In any auditing situation, the auditor
- perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.

Q2. What are financial statements? Who are the users of financial statements?

- "Financial statements" is a set of documents which show the result of business operation during a period, how the result was achieved & position of assets & liabilities on a given date.
- They are ordinarily prepared and presented annually.
- Financial Statements mainly includes the following:
  - Profit & Loss Account: It shows the results of the operations of an entity during a period, in form of profit or loss.
  - Balance Sheet: It shows the position of assets & liabilities at a given date.
  - Cash Flow/Fund Flow Statement: It shows the movement of cash/funds during a period.
  - Other statements and explanatory notes which ordinarily comprise a summary of significant accounting policies and other explanatory information.

Users of Financial Statements
1. Management: To evaluate performances & profitability of business and to make decisions about business.
2. Owners: To get informed about the stewardship of management.
3. Investors: To make decision on investment in a company.
4. Credit rating services: To decide about the credit worthiness of entities.
5. Bankers: To determine financial position & strength of entity.
6. Lenders/Creditors: To decide whether to lend money or not & to examine degree of safety of their money.
7. Government: To levy various taxes and regulate the socio-economic state of affairs.
8. Financial analysts: To assess the performance of an entity.
9. Employees: To raise demands for bonus and other performance incentives.

Q3. ☑ Who is an Auditor? What qualities should an auditor possess?

The person conducting audit is known as the auditor; he makes a report to the person appointing him in the form of an opinion on financial statements after due examination of accounting records and statements.
Audit has to be conducted by a person having good knowledge of auditing & accounting concepts. In India, as per Companies Act, 1956 only Chartered Accountants can conduct audit of companies.

Qualities of an Auditor
- As per SA 200:
  - Integrity: Auditor should be straight forward, honest & sincere in performing his duties.
  - Objectivity: He should be fair & unbiased in his approach.

- Independence: He should maintain an impartial attitude and be free of any interest. His judgment should not be affected by the wishes or directions of another person.
- Professional judgment: He should apply relevant training, knowledge & experience in making decisions.
- Professional skepticism: He should have questioning mind and be alert to conditions indicating doubts.

- He should have a good knowledge of:
  - The general principles of law (Contracts Act, Partnership Act, etc.)
  - The Nature of clients business
  - General economic trends and scenario
  - Specific regulations & provisions (Companies Act, Trust Act, etc.)
  - Accounting & auditing concepts (AS, SAs, Principles, etc.)
- He should continuously update his knowledge.
- He should have adequate practical experience under proper supervision.

Q4. ☑ What are the objectives of audit?

Primary Objective - Expression of Opinion

- The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. His opinion helps determination of true and fair view of the financial position and operating results of an enterprise.
- He should obtain reasonable assurance about whether financial statements as a whole are free from material misstatement. Auditor's opinion is not an absolute assurance due to inherent limitations of audit.
- The auditor should review and assess the conclusions drawn from audit evidences and on this basis form an overall conclusion as to whether:
  a) the financial information has been prepared using **acceptable accounting policies**, which have been consistently applied;
  b) the financial information complies with relevant regulations and **statutory requirements**;
  c) there is **adequate disclosure** of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.
- The audit report should contain a clear written expression of opinion on the financial information.

Secondary Objective - Detection of fraud & errors

- The auditor has to see that what the statements of account convey is true and not misleading and such errors & frauds do not exist as to distort what the accounts really should convey.
- If an auditor has a suspicion of existence of any fraud then he must extend his audit procedures to clear the doubts. His duty is to detect a fraud not to prevent it.
- An auditor is not bound to be a detective or to approach his work with suspicion. **He is a watch-dog, but not a bloodhound.** Any undetected fraud in accounts, which can't be observed in normal course of examination of accounts, will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. *Re-Kingston Cotton Mills Co. (1896)*
- The ultimate responsibility for control over Frauds & errors is of the management. So, management should install controls to ensure compilation of reliable statements of account. Auditor should review the control systems and may provide management with suggestions for improving controls.

In case of major discrepancies in books of accounts, how will auditor's performance be judged?

If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

1. Reasonable Care: whether the auditor has exercised reasonable care and skill in carrying out his work.
2. Special efforts required: whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts.
3. Suspicious: whether auditor had any reason to suspect the existence of the errors and frauds.
4. Deep laid: whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

Q5. ☑ Distinguish between errors & frauds with examples.

Basis	Errors	Frauds

Meaning	Error is a mistake, generally done unintentionally and involuntarily. It is an unintentional misstatement in financial statements by way of: - clerical mistakes in records - mis-interpretation of facts - misapplication of A/cing policies	Fraud is an intentional error, with an intention to deceive, to obtain an unjust or illegal advantage. It includes sophisticated and carefully organized schemes designed to conceal truth.
Intention	Generally done unintentionally, with no intention to conceal.	Done intentionally, with an intention to conceal truth
Alert	May not require a high alert for an auditor	May require an auditor to be very alert as there is implication of dishonesty
Detection	May be easy to detect and can be detected without special efforts	Generally very difficult to detect without special efforts
Reporting	May not be required for errors detected	Should be done for frauds detected & the responses to them

Q6. Give the various types of errors.

Errors, on the basis of

Nature

1. Self-revealing/not self-revealing
2. Intentional/Unintentional
3. Concealed/Unconcealed
4. Affecting GL/ Not affecting GL

Accounting Incidence

1. Errors of Omission
2. Errors of Commission
3. Errors of principle
4. Compensating errors

On the basis of Nature

Type of error	Meaning	Example
Self revealing	Errors whose existence becomes apparent in the process of compilation of accounts.	• Wrong totaling • Omission to post a part of a journal entry to the ledger.
Not self revealing	Errors which do not reveal themselves during preparation of accounts and can be known by detailed analysis.	• Capital expenditure shown as revenue expenditure
Intentional	Deliberate mistakes done with some purpose i.e. Fraud.	• Misappropriation of assets/goods • Forgery
Unintentional	An innocent or non-deliberate mistake, due to ignorance.	• If cashier forgets to reconcile the bank balance as per books of accounts with bank statement
Concealed	Errors accompanied by an effort to hide them, so that they remain undisclosed. They can be known only after careful checking.	• Theft of cash with an effort to do wrong casting in cash book
Unconcealed	Apparent errors, with no efforts to hide them.	• Wrong totaling
Affecting General Ledger	Errors due to which trial balance does not tally, generally one sided errors.	• Expense of Rs. 100 entered correctly in the expense account but Rs. 10 in cash book.
Not affecting GL	Errors which do not affect the trial balance, generally two sided errors.	• No provision for bad debt/depreciation

On the basis of Accounting Incidence

Basis	Errors of Omission	Errors of Commission	Errors of Principle	Compensating Errors
Meaning	Errors to not record a transaction, either wholly or partly in the books	Error to make incorrect or wrong entries in the books of account	Error to not observe fundamental principles of A/cing while making entries	Errors counterbalanced by other errors, not affecting trial balance
Nature	Clerical Error	Clerical Error	Technical Error	Technical Error
Types	• Partial Omission - recording only one aspect of a transaction, either Dr. or Cr. • Complete Omission – omitting to record both aspects of a transaction	• Posting Errors – entry with wrong account/ amount/ side • Casting Errors – wrong totaling or balancing • Duplication errors – making an entry twice in the books of entry & also posting in the ledger • Carry forward errors – C/F with wrong amount/ account/ side	• Errors affecting Profits • Errors not affecting Profits	• Errors affecting profits • Errors not affecting profits
Example	Sales to A entered in account of A but not in Sales Account.	Sales to A entered as sales to B	Sales of Fixed Assets to A considered as a part of P&L	Sales to A for Rs. 100 posted correctly in books but with an amount of Rs. 10.
Effect on Trial Balance	• Partial Omission will affect T/B • Complete omission will not affect T/B	• One sided errors will affect T/B • Two sided errors may not affect T/B • Duplication error may not affect T/B • Casting error may affect T/B	May not affect the trial balance	Will not affect the trial balance

Q7. Write a note on Procedural Errors.

- An accounting system includes both records and procedures. Any breakdown in the laid down procedures may result in an error. Errors which occur in the implementation of the procedures may be termed as procedural errors.
- This type of error cannot be located by any rigorous examination of the books of account.
- Example: It is the normal procedure that goods when received should be inspected for quality by the inspection department staff. If the storekeeper carried out this function it is indeed risky. Similarly, if the procedure requires that the timber godown should have been given periodical insecticide treatment and management has ignored that, a great loss may be caused to the timber by white ants.

Q8. What do you mean by the term Fraud and what are the types in which fraud occurs?

As per SA 240, Fraud is an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. 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'. Risk of management fraud being undetected is higher than risk of employee fraud being undetected.
As per SA 240, frauds can occur in two types:
1. Fraudulent Financial Reporting
2. Misappropriation of assets

1. Fraudulent Financial Reporting: It involves **intentional misstatements** in financial statements with an intention to deceive and conceal truth, by way of:
   - Manipulation, falsification or alteration of accounting records or documents
   - Misrepresentation or omission of transactions or information
   - Misapplication of accounting principles
2. Misappropriation of assets: It involves **theft** of an entity's assets accompanied by falsification of records to conceal the fact.

Examples of Fraud: Defalcation of cash, Teeming & Lading, Misappropriation of goods and accounts.

Q9. What are the Auditor's responsibilities for detection of Frauds & Errors?

- The primary responsibility for prevention and detection of fraud rests with both those charged with governance and management.
- Auditor should conduct audit in accordance with SAs and obtain reasonable assurance that financial statements are free from material misstatement. However, due to inherent limitations of audit, an unavoidable risk of some material misstatements being undetected will always prevail.
- Auditor's ability to detect fraud depends on factors such as skillfulness of the perpetrator, frequency and extent of manipulation, degree of collusion involved, relative size of individual amounts manipulated, and the seniority of those individuals involved.
- Auditor shall consider the following for assessment of risk of fraud:

1. Audit Planning: The auditor should consider **risk of material misstatement** during planning & performing audit by inquiring management regarding occurrence of any fraud during reporting period and he should modify audit procedures accordingly, if necessary.
2. Identified Misstatements: If circumstances indicate possible existence of fraud or error, then he must, consider **potential effect** of suspected fraud or errors on the financial statements, and perform **additional audit procedures** in case of material effect on financial statements
3. Effect on Financial Statements: The auditor should ensure that the effect of fraud is **properly reflected** in financial information. He should consider relevant **laws & regulation**s or may obtain **legal advic**e before expressing opinion, if he is unable to obtain evidence to confirm or dispel a suspicion of fraud
4. Reporting: The auditor should:
   - **Communicate** relevant issues to management or those charged with governance on timely basis.
   - Consider the implication of fraud or errors and **frame his report appropriately** by making a suitable disclosure in his audit report.
5. Documentation : The auditor should document the following:
   - **Fraud risk factors identified & appropriate response** to any such factors
   - **Fraud risk factors & additional audit procedures** in relation to them
   - **Auditor's reasoning** on all significant matters requiring **auditor's judgment** along with his conclusion.
6. Withdrawal from engagement: If as a result of a fraud or error, it is difficult for an auditor to continue audit then he may withdraw from engagement. The auditor should:
   - **Discuss** all facts with the management or those charged with governance
   - Consider his responsibilities towards **appointing authority**
   - Consider his responsibilities towards **regulatory authorities**
7. Communication with Incoming Auditor: He should make appropriate disclosures to the incoming auditor about the **reasons of his withdrawal** or any other relevant issue.

Q10. What do you mean by the term Fraud risk factors? Explain by giving examples.

Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud are known as Fraud risk factors. They may be classified on the basis of three conditions generally present when a fraud occurs, namely Incentives, Opportunities and Attitudes.

- **Examples** of Fraud risk factors relating to misstatements resulting from Fraudulent Financial Reporting:
  - Excessive interest by mgt. in maintaining or increasing the entity's stock price or earnings trend by use of unusually aggressive accounting policies.
  - Mgt. presents unrealistic forecasts to analysts, creditors or third parties.
  - Mgt. pursues means to minimize earnings for tax savings
  - Single person domination in management
  - No monitoring of significant controls by mgt. and no timely action on known material weaknesses
  - Disregard for regulatory authorities by mgt. or history of non-compliance of laws & regulations

- Strained relationship between management & auditors.
- High degree of market competition
- Declining industry with increasing business failures & fall in customer demand
- New accounting, statutory or regulatory requirements affecting entity's performance
- Inability to generate cash flows
- Significant related party transactions which are unusual & unaudited
- Unusually high dependence on debt and significant pressure to increase capital

• **Examples** of Fraud risk factors relating to misstatements resulting from misappropriation of assets:
- Large amounts of cash on hand
- Inventory characteristics, such as small size combined with high value and high demand.
- Lack of appropriate management (Eg: inadequate monitoring of remote locations).
- Lack of an appropriate system of authorization and approval of transactions
- Poor physical safeguards over cash, investments, inventory or fixed assets.
- Lack of mandatory vacations for employees performing key control functions.

Q11. What are the various aspects to be covered in an audit?

The principal aspects to be covered in an audit of final statements of account are:

1. **Internal control:** Examination of internal control system to ascertain if it is adequate and reliable.
2. **Accounting System:** Examination of a/cing system to see if it is properly recording all transactions.
3. **Books of accounts:** It includes:
   - **Arithmetical Accuracy:** Checking of the arithmetical accuracy of the books of account
   - **Evidence:** Examining the entries in the books of accounts with the relevant supporting documents to ascertain that the entries are true.
   - **Completeness:** Ascertain that the books contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed.
   - **Authorisation:** Verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded.
   - **Accounting Principles:** Ascertaining that the accounting principles have been followed correctly like by seeing that a proper distinction has been made between items of capital and of revenue nature.
4. **Financial Statements Analysis:** Ascertaining that the balance sheet and P&L account or other statements are in accordance with the underlying records.
   - **Verification of Balance Sheet items**
   - **True & Fair View:** Checking that financial statements depict a true & fair view of the state of affairs and of the profit and loss of the organization.
   - **Statutory Compliance:** Verifying that final accounts are drawn in the format prescribed by law and all the statutory requirements have been complied with.
5. **Reporting:** Reporting to the appropriate authority whether the financial statements reveal a true and fair view of the state of affairs and of the profit and loss of the organization.

Q12. What is the scope of audit as per SA200 on 'Overall objectives of independent auditor and conduct of audit in accordance with SAs'.

The auditor should:

- Give an opinion whether financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework and comply with relevant regulatory requirements.
- Obtain reasonable assurance about whether financial statements as a whole are free from material misstatement.
- Report on financial statements and communicate as required by SAs, as per his findings. **Constraints on the scope** of audit that impair the auditor's ability to express an unqualified opinion should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.
- Due to **inherent limitations** of an audit, there is an unavoidable risk that some material misstatements may remain undiscovered. However, such discovery is not the main objective of audit, but when there is a doubt of material misstatement, auditor should amend his procedures to confirm or dispel his doubt.
- He must keep the concept of **materiality** in mind, material items can be judged on the basis of the auditor's professional experience and judgment.

- The auditor is not expected to perform duties which fall **outside the scope of his competence**. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

Q13. Write a note on SA200 on 'Overall objectives of independent auditor and conduct of audit in accordance with SAs'.

- **Preparation of Financial Statements:** The audit of financial statements does not relieve management or those charged with governance of their responsibilities. They have responsibility:
  - i. For preparation and presentation of financial statements as per the applicable financial reporting framework including the design, implementation and maintenance of relevant internal control.
  - ii. To provide auditor with:
    - a. All information, that are relevant to preparation and presentation of financial statements;
    - b. Any additional information that auditor may request and
    - c. Unrestricted access to those within entity from whom auditor wants to obtain audit evidence.

- **Requirements from auditor**: Auditor shall:

1. **Comply with relevant ethical requirements**, including those pertaining to independence, relating to financial statement audit engagements. It ordinarily comprises the Code of Ethics issued by the ICAI. The Code establishes the following as fundamental principles of professional ethics relevant to auditor:
   1. Integrity;
   2. Objectivity;
   3. Professional competence and due care;
   4. Confidentiality; and
   5. Professional behavior.
2. **Plan and perform audit with professional skepticism** by being alert in recognising circumstances that may cause financial statements to be materially misstated. Auditor may accept records and documents as genuine unless he has reason to believe the contrary. In case of doubt about the reliability of information he should investigate further and determine the modifications or additions to audit procedures necessary to resolve the matter.
3. **Exercise professional judgment** in planning and performing an audit. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor.
4. **Obtain sufficient and appropriate audit evidence** to reduce audit risk to an acceptably low level. Sufficiency and appropriateness are interrelated.
5. **Conduct an audit in accordance with SAs**: Auditor shall comply with all SAs relevant to audit. He should:
   - Understand the entire text of an SA, including its objectives, scope, requirements, etc.
   - Not report compliance with SAs unless he has complied with requirements of all relevant SAs.
   - SAs do not override laws and regulations that govern an audit of financial statements.

Q14. What are the inherent limitations of audit?

As per SA 200, Auditor obtains reasonable assurance about whether financial statements as a whole are free from material misstatement. Auditor's opinion is not an absolute assurance due to inherent limitations of audit. The inherent limitations of an audit arise from the:

1. <u>Nature of financial reporting</u>: Preparation of financial statements involves judgment by management including subjective decisions, assessments or a degree of uncertainty in estimates made. There are chances of bias in management's judgments.
2. <u>Nature of audit procedures</u>: There are practical and legal limitations on auditor's ability to obtain audit evidence. For e.g. test checking, reliance on internal controls, nature of evidence which is persuasive rather than conclusive and use of judgment by auditor. As auditor is not investigator so he does not have specific legal powers such as power to search.
3. <u>Timeliness of audit and balance between cost & benefit</u>: It is impracticable to audit all existing information or to pursue every matter exhaustively to find a misstatement.

Because of inherent limitations of audit, there is an unavoidable risk that some material misstatements may not be detected, even though audit is properly planned and performed as per SAs.

Q15. What are the various types of audit?

Audit may be classified as:

1. Statutory/Mandatory Audit: It is an audit required under law. The organizations which require such audit are:

S.No.	Organization	Governing Statute
1	Companies	Companies Act, 1956
2	Co-operative Societies	Co-operative Societies Act, 1912
3	Banking companies	Banking Regulation Act, 1949
4	Electricity supply companies	Electricity Supply Act, 1948
5	Public and charitable trusts	Indian Trusts Act, 1882
6	Insurance Companies	Insurance Act & Companies Act
7	Specified entities	Income-tax Act, 1961

2. Independent/Voluntary Audit: It includes all other audits which are not required under law and performed at the discretion of the governing body. E.g. Audit of accounts of proprietary entities, partnership firms, private trusts, Hindu undivided families, non-profit making institutions like schools clubs and hospitals which are not governed by any statute or specific acts. They may opt for an audit owing to various advantages of an independent audit.

Q16. What do you mean by the term "independent audit"? What are the advantages of independent audit?

Audit which is not a statutory audit may be termed as an independent audit. It is not compulsory by law and is performed at the discretion of the governing body of the entity. It provides following advantages:

1. Acts as a moral check on the employees from committing defalcations or embezzlement.
2. Helps to detect wastage/losses, especially that occurring from inappropriate internal controls.
3. Ascertains whether the books of accounts and records have been properly kept.
4. Helps in review of internal checks and internal controls.
5. Provides reliable financial statements to easily understand the state of affairs.
6. Helps in settlement of accounts at the time of admission or death of partner.
7. Helps in settling liability for taxes.
8. Helps in negotiating loans with the banks.
9. Helps in settling insurance claims in respect of damage suffered by property.
10. Helps in determining the purchase consideration for a business.
11. It is used for settling trade disputes for higher wages or bonus.
12. Required by Government before it gives assistance or issues a license for a particular trade.

Q17. What is the difference between auditing & accounting?

Basis	Auditing	Accounting
Meaning	Audit is an independent examination of financial information of an entity with a view to express an opinion.	Accounting is the art of recording, classifying & summarizing financial information & preparation of reports thereon.
Objective	To find out whether the accounts show a true & fair view and report thereon.	Recording of transactions & preparation of financial statements
Aspect	It covers examination aspect of Financial Statements	It covers recording aspect of Financial Statements
Conducted by	A qualified chartered accountant	Any person having knowledge of accounting
Principles followed	Done as per the standards on auditing (SAs)	Done as per the accounting standards (AS)
Different subjects	It requires good knowledge of various subjects like law, accounting, auditing, economics, statistics, etc.	It requires good knowledge of accounting concepts and accounting standards.

Q18. What is the difference between audit & investigation?

Basis	Audit	Investigation
Meaning	Audit is an independent examination of financial information of an entity with a view to express an opinion.	Investigation is a critical examination of the accounts with a special purpose.
Objective	To find out whether the accounts show a true & fair view and report thereon.	For some specific purpose to ascertain certain facts
Scope	Scope is wider, to cover all transactions affecting financial statements	Scope is limited as regard the period or area to be covered
Frequency	Auditing may be a regular exercise	Investigation is generally done as and when required
Detection of error/fraud	Secondary objective	Primary objective
Test Checking	Test checking is generally allowed in auditing	Generally Test checking is not advisable & in many cases 100% checking may be required.
Suspicions	Auditor does not plan an audit with suspicions in his mind about the financial informations	Investigator starts his work with suspicion & work towards confirming or dispelling it.
Reporting Authority	Owners or shareholders	Person on whose behalf investigation is undertaken

Q19. How is auditing related to different fields?

Auditing related to	Relation
Accounting	• Auditing starts where accounting ends • An auditor has to possess complete knowledge of the accounting concepts as he has to examine the accounts accordingly
Law	• An auditor has to check if the transactions confirm with the statutory requirements • So, he should have good knowledge of the laws affecting the client • He should have knowledge of law of contracts, taxation laws, etc.
Economics	• Auditor should have knowledge of the business of the client & the economic environment in which it operates • He should be aware of the economic force that affect the firm, relationship of price, role of government and government regulations
Language	• For effective communication whether oral or written he should have good command over language
Behavioral Science	• Audit involves interaction with lot of people involving client, client's staff, audit staff, legal experts, technicians, etc. • He has to see if the persons providing information are acting honestly & competently. • He should have the tact of getting along with people
Statistics & Mathematics	• Auditor has to do audit on the basis of sampling, for effective selection of samples, he should have knowledge of the sampling tools • For analytical procedures, he should have knowledge of the ratios analysis • He have to check the arithmetical accuracy of the books • He have to check various calculations, like depreciation, interest, etc.
Data Processing	• Nowadays, accounting is getting computerized, so an auditor has to be computer savvy. • He have to apply Computer Assisted Audit Techniques (CAATs)
Financial Management	• He should have knowledge of various financial techniques like working capital management, funds flow, ratio analysis, capital budgeting, etc. • Also, a fair knowledge of the market place, various financial instruments & the institutions affecting market

Business operations	• A good auditor is one who understands client and his business well • It will help in making effective evaluation of the internal control system • He should also understand the cost system in operation

Practical Questions - Chapter 1: Nature of Auditing

Q1. "The audit of Financial Statements relieves the management of its responsibilities".

Q2. "The auditor is only a watchdog, not a bloodhound".

Q3. After the accounts of M/s ABC Ltd. were audited a misstatement was found in the books. The management held the auditor responsible for not detecting the misstatement. Is the management right? How will the performance of auditor be judged?

- Errors & Frauds

Q4. While doing physical verification of cash the auditor found that the balance shown in books was Rs. 1 lakh and the actual currency in hand amounted to Rs. 40,000. The cashier agreed to pay for the shortage of cash saying that he was in need of cash so he used it and requested for not reporting for it. Should the auditor consider reporting for it? What if the cashier shows you a complete voucher for cash issued, which he wrongly entered in bank account instead of cash book?

Q5. Identify which of the following amounts to a fraud?
a. Capital expense entered as revenue expense.
b. Capital expense for Rs. 2 Lakhs entered in books as Rs. 3 Lakhs and cash amounting to Rs. 1 Lakh being misappropriated.
c. Cash issued for payment to travel agent for Rs. 40,000 where no such services being used in actual.
d. Giving 20% discount on sales to Tony, where no such policy for discount exists in books.
e. Wrong totalling of cash book.
f. Sales to Tony entered in books as sales to Jonny.

Q6. How will you classify the following errors?
a. Capital expense entered as revenue expense.
b. Goods received not being inspected by the inspector.
c. Sales to Tony entered in books as sales to Jonny.
d. Sales to Tony for Rs. 100 entered in correct accounts but with an amount of Rs. 200.
e. Sales to Tony for Rs. 100 entered twice in books.
f. Opening Stock for Rs. 10 lakhs brought forward with an amount of Rs. 1 Lakh.
g. Sales to Tony for Rs. 100 entered correctly in sales account but no entry made in account of Tony.

- General concepts in auditing

Q7. An auditor is satisfied by the arithmetical accuracy of the books of accounts, should he give an unqualified opinion? What else do you think is required during audit? ➦Q12.

Q8. Mr. Vyom is a sole proprietor with a medium sized business and is thinking whether to get his books audited or not. How can you convince him to get his books audited? ➦Q17.

- True or False

Q9. State whether true or false:
a. Auditor is not an insurer.
b. Unless an auditor is able to discover all frauds and errors, he has not performed its main function.
c. Procedural errors arise as a result of transactions having been recorded in a fundamentally incorrect manner.
d. Auditor compares entries in books of account with vouchers; and, if the two agree, his work is done.
e. Financial Statements includes only P&L A/c and Balance Sheet.
f. The auditor has to approach everyone with suspicion.
g. The main object of an audit is detection and prevention of fraud and error.