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# CLASSICAL AUDITING PRACTICES AND ITS CRITICAL ANALYSIS: A STUDY

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**ABSTRACT**

*To understand better the technological impact on accounting and auditing, we need to understand the classical approaches first. Since auditing procedures largely depend upon the methodology adopted while accounting the financial events in an organization, study of classical approaches of accounting need our careful consideration. Though we will consider what procedures had been used just prior to the advent of computers yet study of accounting and auditing history in brief could fetch us a much better understanding of the entire scenario.*

***Keywords:*** *Standardization, Vouching, Verification, Audit Trail, Materiality, Concurrent.*

## Introduction

Classical or manual auditing practices, though, subsiding gradually cannot be said to be worthless. These still has some relevance. But there are some demerits also that are leading towards its pack-up. In the initial stage, the size of business organizations was limited and so also the number of accounting transactions were. Accounting was conducted by the business owner himself; hence, commission of any fraud being prejudicial to his interest was out of the scope of even imagination. In some other cases, they said task was conducted by a faithful employee called "*Munim*". The commission of fraud was though not impossible yet considered to be rare since all the important accounting events were in direct contact of the owner himself.

Even in such a safe situation, the need of auditing was felt. This is due to the adage "*To err is human; to forgive is divine".* Even if in the absence of mala fide intentions, occurrence of genuine errors cannot be denied. Errors can be quickly identified if the task of such identification is performed by a person other than who performed the accounting task. Auditing is always performed by a person other than that responsible for the proper accounting of financial transactions.

## Classical Scenario of Auditing Practices

- **Initial Stage**

In the initial stage, the size of business organizations was limited and so also the number of accounting transactions were. Accounting was conducted by the business owner himself; hence, commission of any fraud being prejudicial to his interest was out of the scope of even imagination. In some other cases, they said task was conducted by a faithful employee called "*Munim*". The commission of fraud was though not impossible yet considered to be rare since all the important accounting events were in direct contact of the owner himself.

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That is the exactly case with the auditing practices. Auditing is always performed by a person other than that responsible for the proper accounting of financial transactions. In the ancient times, the objects of the auditing practices were limited to:

- **Detection and Removal of Errors:** In the process of performance of auditing, accounting entries are re-checked and re-validated in the light of vouchers and other relevant documents. The task of detection and removal of errors is inherently embedded into the auditing practices.
- **Detection and Prevention of Frauds:** With the passage of time, the moral integrity of humans went downhill. Also, complete supervision of the transactions by the owner of the organization himself grown impracticable due to the expansion in the activities of the organizations. This expansion opened up new vistas for the employees to misappropriate the economic resources of the organization.

Commission of frauds underpinned pervasion of auditing practices in that it posed challenge to auditors to uncover them and to suggest preventive measures against them. Until this stage, frauds were perceived to be perpetrated only by employees and officers against the owner of the organization. Perpetration of the same by the owner himself could not even be thought of at that juncture of time.

- **Corporatization & Government Regulations**

Corporatization segregated management from ownership and owners became dependent upon management for vital financial information. Also, instances of moral turpitude got increased with the passage of time. Frauds started to be perpetrated even by persons associated with the top level management. To overcome this situation, government put forth Acts, Rules and Regulations. These enactments laid down minimum disclosure requirements. Even then, top management remained reluctant in keeping integrity with what was actually intended by the legislature and kept on applying ‘Form over Substance’ theory. As such, they were providing the minimum information as required by the law without caring about the relevance, adequacy and appropriateness of the said information for its users in their decision making process. The condition was further worsened by avoiding even the minimum information from disclosure through slyly exploiting the loopholes in the law. FSs, thus, became puppets in the hands of top management and started functioning as tools of deceiving their intended users. They falsely presented lower profits to evade tax. Likewise, they presented excessive profits to raise loans etc. All these consequences led to the furtherance of auditing. The government regulations started proving insufficient.

The necessity to conduct auditing by independent professionally qualified auditors was felt eminently. In India, ICAI prepares Chartered Accountants (CAs) through inculcating a tough & comprehensive theoretical curriculum and a rigorous practical training schedule before and after attaining such qualification. The Chartered Accountancy Course has been included into the ‘Guinness Book of World Records’ as the toughest educational course in the world. Also, these CAs are kept under strict adherence of ethical exposure. Keeping in view the gigantic number of accounting transactions and complexities involved therein in the corporate organizations, critical analysis of each accounting entry even by the said experts was impracticable. What was important was to ensure that the FSs give true and fair view of the financial affairs and financial position of the organization. Auditors were/are to form an opinion about the truth and fairness of FAs and to express the same in their report to the intended parties basically, the owners.

In this scenario, the prime objective of conduction of auditing was shifted to “**Expression of opinion regarding truth and fairness of FSs”.** Detection of errors and fraud became the inherent yet secondary function of auditing. Errors and frauds automatically get divulged while performing the auditing procedures by the auditors.

- **Standardization**

To ensure the integrity, independence and excellence of auditors and to ensure the auditing stays upto standard, many organizations have come forward globally with generally accepted auditing practices just like that available in case of accounting. In India, they are termed Auditing and Assurance Standards (AASs). A total of 37 AASs have been issued so far. These AASs have recently been categorically classified and termed as Standards on Auditing (SAs).

These SAs encompass a wide variety of methodologies and approaches to be applied by auditors while discharging their duties in different situations. Some of them are - engagement of auditors, evaluation of internal control, receipt of services of experts, auditing in the computerized environment etc.

**Classical Auditing Practices**

Before we proceed towards classical auditing practices, it is worthwhile to understand the term 'Auditing' fully.

"Auditing is an act of application of Generally Accepted Auditing Practices upon accounting records of an organization by a person, generally, independent of the persons responsible for preparation and maintenance of such records, so as to enable him to form and to express his opinion to the intended parties, generally, owners of the organization regarding truth and fairness of information disclosed by the organization by way of Financial Statements."

Thus, it is amply clear that an effective audit consists of:

- **Independence:** Auditor should be independent of the persons associated with the preparation and maintenance of accounting records. If he is one among such persons or under significant influence of such persons, not only detection and revelation of fraudulent activities of such persons would be greatly hampered but also detection and rectification of errors being crept in the accounting records would also be interrupted to a considerable extent.
- **Opinion:** In his report, auditor expresses his opinion about truth and fairness of information intended to be presented through FSs. It is just an opinion; not a guarantee. Auditing is generally conducted by a professionally qualified person so his opinion is highly appreciated by intended user groups by keeping reliance upon his competence.
- **GAAPs:** To form his opinion, the auditor accomplishes his task by using Generally Accepted Auditing Practices which are known as SAs in India. Under SAs, auditing is treated different from Investigation. Under investigation, role of investigator is supposed to be as a blood hound i.e. work is performed being in a doubtful state of mind – that there is essentially something wrong somewhere. While role of auditor is just as a watch dog i.e. work is performed with the contentment of mind unless there is something igniting the doubtful state of mind. If the surrounding conditions cause any raise of doubts, the situation is probed from top to the bottom of such doubts.
- **Intended Party:** Owner or group of owners of the organization is still the principal party because the resulting report of the audit work conducted by the auditor is aimed at them but hopefully this report is taken for granted wholeheartedly by other user groups also. Even though separate report is prepared for taxation purpose, the information required in such report is obtained without application of much different methodologies. In other words, the methodologies applied in the main audit work are sufficient enough for taxation purposes also.

Since the task of audit is application of Generally Accepted Auditing Practices upon the accounting work performed by the employees of the organization under audit, the task is accomplished by following some special procedures keeping in view the rules directed in SAs. These procedures are:

- **Compliance Procedures**

These procedures are conducted first of all because the results obtained under these procedures play a vital role in deciding the scope of other procedures that are going to be applied later on. Also, the sanctity of entire audit task is dependent upon these procedures due to the fact that audit is conducted in a content state of mind; hence, most of the audit procedures are performed on test check basis. If the result of these procedures is found to be satisfactory, a sample of fewer items is chosen by the auditor for further study and vice versa.

Under these procedures, the auditor prepares himself by obtaining the knowledge about the nature & size of the business of the organization; various internal controls adopted by the organization and the degree of effectiveness of usage of these controls. These procedures also enable the auditor to find out areas in which the errors might creep in and that tempting to commitment of frauds. These procedures, as such, play a dominating role over other procedures i.e. substantive procedures by affecting the scope of entire audit work significantly.

Compliance procedures are mainly conducted through obtaining theoretical knowledge of business environment of the organization through a well designed questionnaire and observation of the actual pervasion of the same. Here are some pieces of the information that are sought to be retrieved in such questionnaire; the list is not exhaustive, however:

- What is the nature of the business of the organization? (Trader, Manufacturer or Service Provider);
- What is the size of the business? (Small, Medium or Big);
- Is the organization comes under the ambit of specific law of legislation? (Companies Act 1956, Banking Regulations Act 1949, Insurance Regulatory Act 19 etc.); Does the organization have its own rules & regulations? ;
- Does these rules & regulations provide for internal controls and internal checks? Etc.
- Keeping in view the information obtained through the questionnaire, the auditor closely observes the working environment of the business, prepares his mindset regarding the adequacy and efficacy of the internal control measures being followed by the organization and the extent of usage of other procedures i.e. substantive procedures.

- **Substantive Procedures**

These are the procedures adopted to verify the validity & sanctity of the information displayed through the financial statements, with respect to the available documents supporting the financial transactions. The application of these procedures comes forward in furtherance of the confirmation of the raw mindset developed by the application of compliance procedures. As such, the auditor becomes able to form his opinion regarding truth & fairness of the information displayed in the FSs.

The followings are the part & parcel of these procedures:

- **Audit Plan:** After the observation of the organization’s working environment, an audit plan is prepared. Under this plan, the followings are worked out and kept ready before hand:
  - Keeping in record the secret coding of the various tally marks to be used in the audit;
  - Total time to be devoted in the conduction of the audit;
  - Number of audit assistants to be deployed; and
  - Fixation of the sample size for test checking.
- **Audit Programme:** Keeping in view the result of the compliance procedures, a detailed audit programme is prepared. The programme contains data regarding the extent of application of various tools of substantive procedures, the time to be devoted to each tool, the assistant authorized for the application of a specific tool, the extent of the time required of the auditor himself for supervision of the audit work being conducted by his assistants etc.
- **Vouching:** A voucher is a document generated at the initiation of an accounting event and vouching is an audit tool to check the validity & sanctity of the voucher itself; of the entries made into the journal; and of the posting thereof into the ledger. The balances shown against the names of the ledger accounts in the trial balance are matched with that in the ledger. Likewise, Financial Statements are verified with the balances shown in the trial balance mutatis mutandis the required adjustments. Under the vouching procedure, the following points must be taken care of:
  - Only valid voucher must have been accounted for;
  - A particular voucher must have been accounted for only for once; and
  - No valid voucher must have been escaped from the accounting process.
- **Verification:** Under this procedure, all assets, be it tangible or intangible, of the organization are verified in the following manner:
  - The title of a particular asset under verification is in favour of the organization.
  - In case of tangible assets, they are physically in the possession of the organization.
  - The assets in the possession of the organization are same as described in the title deed.
  - No asset has been accounted for twice.
  - No asset has been escaped from the accounting process.
  - No asset in possession of the organization under operating lease (i.e. under hiring agreement) has wrongly been shown as purchased by the organization and
  - No asset under possession of the organization under financial lease agreement (i.e. under purchase agreement) has wrongly been shown as has been possessed under hiring agreement.
- **Other Tasks:** Besides vouching and verification, various other tasks are performed to comply with the provisions of various laws applicable to the organization and that of rules &

regulations of the organization itself such as preparation of LFAR (Long Form Audit Report) and Ghosh & Chore Committee reports in case of banking company, report under CARO (Companies [Auditor's Report] Order, 2003) etc.

- **Audit Report**

This is the culmination of the entire audit task. The result of application of all the audit procedures is compiled in a manner to form an opinion about truth & fairness of the information being displayed through financial statements of the organization. Audit report may be of the following types according to the result of various procedures applied by the auditor:

- **Clean Report:** This report is the indication of the satisfaction of the auditor regarding truth & fairness of the information being displayed by financial statements. This exhibits the fact that neither a material fact has been kept away from a designated place in the financial statement nor it has been displayed in a deteriorated way so as to provide a misleading picture of the financial status of the organization.
- **Qualified Report:** When the information shown in the financial statements is true & fair in the opinion of the auditor but some exceptions, not material enough to adversely affect the status of the truth and fairness of FSs, are also persistent, this kind of report is generated by the auditor. Examples of these exceptions are – Non-disclosure of a change in accounting policy, improper classification of a certain item of inventory etc.
- **Negative Report:** When there is serious defect in the formation or conduction of internal control measures adopted by the organization and the procedure applied by the auditor points towards the events that materially put question mark upon the truth and fairness of the information being displayed by the financial statements of the organization, the auditor expresses negative opinion through this type of report.
- **Disclaimer of Opinion:** Various kinds of information are required while conducting audit. Many times, it may not be readily available to the auditor for many reasons like seizure of accounting records by taxation authorities, management being not interested in providing the same etc. In these cases, the auditor can not apply compliance and substantive procedures for want of required information. As a result, the audit task becomes inoperable and the auditor finds him/her unable to form an opinion upon the truth and fairness of the information contained in the financial statements under consideration and disclaims him/her from expression of opinion.

**Audit Risk and Auditor's Responsibility**

In an audit assignment, a number of audit risks are involved. An auditor has to recognise different types of the audit risks attached to a particular audit assignment. He/she has to deploy various resources to identify the risks and their significant implication upon the overall presentation of the financial statements. Audit risk assessment is a very vital part of overall audit assignment and it has a deep impact upon the formation of the opinion of the auditor regarding the truth and fairness of the financial statements. SA 315 (i.e. Standard on Auditing 315) along with SA 240, SA 330 and SA 450 specifically deals with the risks associated with the material misstatement of the financial statements. According to SA 315, there can be the following types of risks attached to the presentation of the financial statements:

- **Risks of Material Misstatement at Financial Statement Level:** Risks of material misstatement at the financial statement level refer to the risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.
- Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

- **Risks of Material Misstatement at Assertion Level:** Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

**Critical Analysis of Classical Auditing Practices**

Each and every coin has two aspects – the one is the head and the other is the tail. Likewise every comfort comes with the discomfort associated with it. Classical auditing practices have some merits and demerits.

**Merits**

- **Physical Evidence:** Classical auditing practices are entirely dependent upon vouchers and other legal documents. These documents are in paper form so they have physical existence. This makes verification of the authenticity of an accounting entry quite easy.
- **Audit Trail:** Accounting is conducted in a logical sequence so each part of the sequence leaves behind an audit trail. To verify entries in journal, vouchers are here for your help; for ledger, it is journal; for trial balance, it is ledger; and so on. Hence, audit trail is readily available.
- **Friendly Language:** All data required in the audit task are available in paper form. The language used upon such papers is commonly used by humans at that particular region and hence, is easily understandable by the auditors. They need not acquaint themselves of any particular language which they are not familiar with.
- **Effect of Errors upon Materiality:** Since the task of accounting is conducted by humans, chances of remaining errors in the task can not be denied. But the cherishing fact is that the task is accomplished by different persons in various consecutive stages and an error committed by a person is generally found out by another one. Most of the errors are located in the accounting task itself and remnants, if any, are located and removed during conduction of audit task. So, chances of an error becoming so compound to challenge materiality are quite few.
- **Fraud Detection:** Under classical auditing approach, any type of change in any voucher or document is easily noticeable through the naked eyes and any questionable change in such documents helps in the in-depth inquiry of the same. Also, auditor uses various secret tally marks so that any change in them after the completion of the audit task is somewhat difficult and easily detectable at a later date. Having regard to all these facts, fraud detection is somewhat easy.
- **Traditional Methodology:** Tools being used under classical approach are being used by the auditors for considerably a large span of time. The auditors are well acquainted of them and can use them appropriately without any trouble or hesitation. They need not equip themselves with any other specific knowledge or expertise in using the same.
- **No Special Equipment:** Task of audit is conducted in traditional manner. Though some tradition equipments are needed in the task like pens, pencils, markers, papers, file covers, electronic calculators etc. but no other special gadget is needed in the task.
- **Safety of Records:** Accounting task is accomplished using various paper books and paper documents. In case of any damage to any book or any document, the lost data can be regenerated with the help of other books or documents. The shelf life of paper books is sufficiently long. This is also a positive aspect to be considered for.

**Demerits**

- **Bulky Records:** If the organization under audit is sufficiently large, the auditor has to go through significantly large quantity of books. In this process, some important records may escape from the eyes of the auditor and if there is so, it might impair the formation of the auditor's opinion and auditor can be held to be liable for such an act. Also, the file of audit working papers of the auditor himself/herself becomes quite bulky at the time of completion of audit.
- **Time Consuming:** The task of auditing is conducted without using any hi-tech equipment so application of various procedures and tools under auditing process becomes a time consuming

process. The auditor presents his opinion as his report in the delayed manner and the overall reporting process of the organization under audit becomes a belated fashion.

- **Humdrum Task:** Some of the tools of auditing process require repetition of a particular task like vouching of the accounting entries and tallying the totals of subsidiary books & ledger accounts. These tasks are generally performed by the junior staff or the articled clerks and audit clerks of the auditor. The presence of repetition & reiteration makes a task boring and there is a great chance of ignorance of some important facts. This boringness of the audit staff leads to the impairment of the quality of overall audit work.
- **Costly:** Audit under classical scenario requires much time and resources so it becomes a costly exercise to do both for the organization under audit and the auditor. In the physical verification of the assets, particularly the stock, the normal functioning of the organization gets hampered greatly till the completion of the task and this costs the organization very much. For auditor also, the consumption of greater time & resources leads to greater cost of staff remuneration and boarding & lodging.

### Significance of the Study

This paper discusses about the Classical Scenario of Auditing Practices and Its Critical analysis. This paper is helpful to understand the following areas:

- Corporatization & Government Regulations in respect to Auditing Practices.
- The tools and techniques of Classical Auditing Practices.
- The Essentials of effective auditing work e.g. Compliance Substantive Procedures.
- Types of Audit Report.
- Audit Risk and Auditor's Responsibility.
- The Merits and Demerits of Classical Auditing Practices.

### Review of Literature

Review of literature paves way for a clear understanding of the areas of research already undertaken and throws a light on the potential areas which are yet to be covered. The reviews of some of the important studies are presented below.

- **According to Internal Audit Standards Board (IASB) of ICAI:** The existing and emerging internal audit practices need to be review worldwide and find the areas in which Standards on internal Audit (SIAs) need to be developed.
- **According to Auditing and Assurance Standards Board (AASB) of ICAI**: In the present Scenario industries have to review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.

### Research Methodology

The prepared paper is a descriptive study in nature. The study has been carried out based on the collection of the relevant sources such as published books, articles, published in different journals and newspapers, periodicals, conference paper, working paper and websites etc.

### Conclusion

The most versatile and modern objective of auditing is the expression of opinion upon truth and fairness of financial statements. This is a broader concept and encompasses both detection of errors and fraud. To ensure the correctness of the accounting results, therefore, a need of checking of the work of accounting by a person other than who has originally carried out the accounting task was felt. This perception gave birth to the concept of auditing.

The evolution of auditing is submissive to the advent of accounting. It starts where accounting has accomplished its work. It is the task of checking out what have been carried out under the task of accounting. At the initial stage of development of accounting when number of financial transactions were countable on finger-tips only, the nature of those transactions were simple and the accounts were kept by the businessman himself or his faithful attendant called "Munim", there was no need of auditing. But as with the growth in the field of accounting, the size of businesses irrupted, the number of financial transactions popped up and the nature of transactions germinated to be more and more complex.

Moreover, greed is also an essential ingredient of human being. To spend life with splendour has always been a reverie. This aspiration of earning quicker also tempted to commit frauds. And frauds are always worse than errors are. Errors, of course, mutilate the financial statements yet less than frauds do. To protect the interest of various parties interested in the financial statements from such errors and frauds, a mechanism called "Auditing" was felt necessary. Under this mechanism work done under "Accounting" is critically examined by an unbiased and independent person.

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