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Strengthening the Capacity of Professional Accountants and their organizations in financial management.

[UNDERSTANDING ERRORS]

What should you know about ERRORS….

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ERRORS

I. Errors

In conducting an audit, the auditor obtains evidence to support whether the financial statement under examination are fairly presented or not. In the course of his search for evidence, the auditors may discover errors, which affect the fairness of the financial statements.

II. Classification of Errors

From the auditor's point of view, errors discovered in the course of the audit may be classified as:

1. Intentional vs. unintentional errors
2. Material vs. minor errors
3. Errors, which are self-revealing vs. errors, which are not self-revealing.
4. Procedural vs. substantive errors.

1. Intentional vs. Unintentional Errors

Intentional Errors: are errors made deliberately with intent to deceive, mislead, or conceal the truth. This may be committed by officers or employees to: 1) hide or conceal misappropriations, 2) hide ignorance or incompetence, (3) to evade taxes, (4) to obtain favorable decisions by government office.

Unintentional Errors: are errors, without intent to deceive, arising from: carelessness, negligence, incompetence, and ignorance.

2. Material vs. Minor Errors

Material Error: An error that may significantly influence judgment based on financial statements and which therefore must be corrected.

Minor Error: An error will not materially affect judgment based on the financial statements and which the auditor may accept without correction.

3. Self-Revealing vs. Not Self-Revealing Error

Self-Revealing Error: An error that is automatically disclosed because of the nature of the double entry bookkeeping system. This kind of errors will be revealed when a trial balance is drawn because it will not balance. Ex we debit $90, but we credit only $80 so the error is $10.

Not Self-Revealing Error: Certain errors that will not automatically be revealed either by the operation of the double entry accounting system: Ex: error of charging.

Errors disclosed by double entry system are: addition or subtraction, posting to the wrong side of the account, error of transposition (e.x 79 recorded as 97).

Errors not disclosed by double entry system: omission of journal entry, recording of transaction twice, undercharging or overcharging the debit and credit sides of an entry, posting to a wrong account. Ex. The invoice amount can't be easily readable so that we do entry the wrong amount (equal debit and credit).

Error disclosed by routine business practices: failure to record the issuance of a check or a cash deposit will not affect the trial balance. Ex. At the end of the month the cash in bank and cash on hand will not balance.

4. Procedural vs. Substantive Error

Procedural Error: Errors involving violation of internal controls. Ex. Failure of an officer to indicate approval on a voucher.

Substantive Error: Errors involve the correctness of amounts or the adequacy of informative disclosures in the financial statements. Ex. Failure to adjust a prepaid item. The effect is asset (insurance, rent…) is overstated and expense is understated.

III. Correction of Errors

1. Correction of Procedural Errors

Procedural errors, which are significant, should be brought to the attention of the auditee so that errors of similar nature should be avoided in the future.

Ex, if vouchers were not signed, the auditor may recommend to ask the auditee to have an authorized official review the vouchers and affix his signature.

Auditor may recommend strengthening internal control for their future effect, as certain erroneous practices can no longer be "undone". Ex. one person was designated as cashier and bookkeeper at the same time.

2. Correction of Substantive Errors

Auditor's action on substantive errors discovered:

* Bring to the attention of auditee,

* Recommend that they be corrected,

* If the auditee accepts the recommendation, the adjustment are incorporated in the financial report,

* If the auditee rejects the recommendation, the auditor would report on the financial report without correction.

IV. Correcting Auditee's Books/Records

Auditor is not in a position to correct financial statement under audit without the auditee's approval. The auditor does not enter correcting entries on the auditee's books. However, the auditor should keep track of all necessary adjustments and note their effect on the financial statements.

1. Errors Affecting (Nominal) Income Statement Account Only

* If auditee's books have been closed, no correcting entry is necessary for the period under examination. Ex. The invoice is for the electricity but we booked to communication account, so it does not affect the income statement.

* On the auditee's book, no correcting entry is needed if the error involved nominal accounts only for a year (s) prior to the period under examination.

2. Errors Affecting (Real) Balance Sheet Account Only

Correcting entries should be done to correct the errors. This would be true whether the books of account have been closed. Ex. Posting to the wrong balance sheet account should be corrected (cash, inventory, account payable…)

3. Errors affecting both (real) balance sheet and (nominal) income statement accounts

If the books have not been closed, for a period under examination, a correcting entry affecting a nominal and balance account is needed. No correcting entry is necessary if the books have been closed.