Discipline Courses-I
Semester-I
Paper: I
Unit-VIII
Lesson: Introduction to Auditing
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Lesson: Introduction to Auditing

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1. Learning Outcomes:

After you have read this lesson, you should be able to:

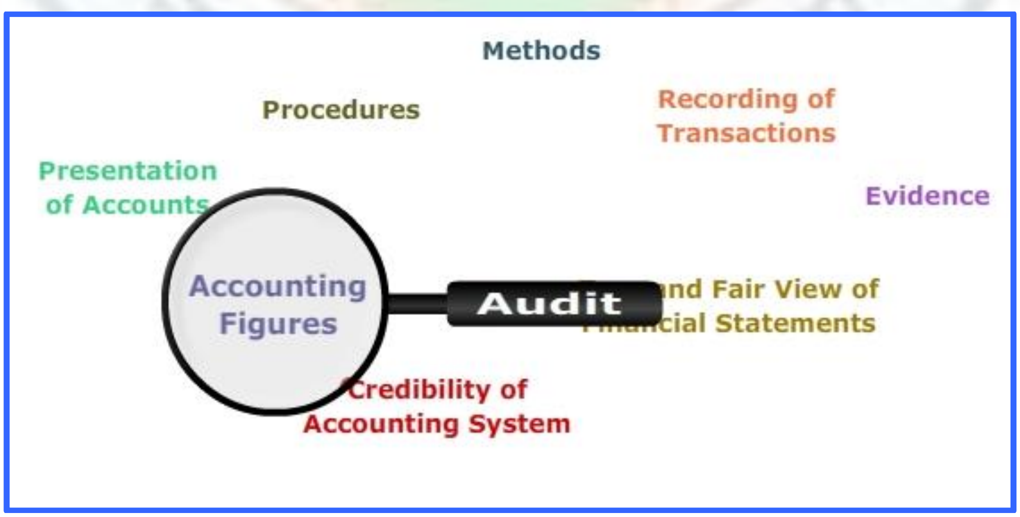
- understand the meaning and objectives of auditing,
- appreciate the need and importance of auditing,
- differentiate between an error and fraud,
- explain different types of errors and frauds,
- comprehend different types of audit and their relevance in different situations or for different organizations.

2. Introduction:

In earlier times businesses were not complex as they are today. Most of the businesses were managed and run by a single person as transactions were less, people involved were less and accounts were not very elaborate thus there were very bleak chances of errors.

Gradually with the growth and evolution of business, the face of industry changed; size of business increased, number of transactions increased. The increase in size and scale of business operations mandated the increase in the number of people managing the operations of business. With division of labour, different people were made to handle different tasks. Departments based on functions were created to organize the business activities to ensuring smooth and efficient performance of duties. Accounting emerged as a separate department or as a separate unit in the finance department in many of the organizations. Certain people with specific skills were appointed to maintain accounts and ensure their accuracy. These persons, so appointed for the task of recording and ensuring accuracy in the accounts, used to listen to all the transactions by the owners of the organization and recorded and verified them. That is how the word 'audit' originated from the Latin word 'audire', which essentially meant 'to hear'. Slowly and steadily the scope of audit increased many fold and it has taken shape of a professional field today. It is said that accounting begins where book keeping ends, and auditing begins where accounting ends. While it is necessary to place trust in the managers and employees of the business, auditing is an attempt to verify the records and financial statements so that others may also place trust in the authenticity of such statements.

Figure 1: Audit



3. Concept of Auditing

The companies generally function with an objective to earn profits or to increase its worth these days. Their worth and market standing is directly related to their performance. Whenever a company performs well, it is reflected in their books of accounts in the form of profits and other items in the balance sheet. The users of this information, namely, investors, bankers, shareholders, etc. rely on such information in order to assess the position of the company. Therefore the information reflected by the books of accounts of a company plays a very crucial role in the investment, financing or other vital decisions of various stakeholders. But this poses an important issue. One needs to judge how far the accounts prepared and presented by the company are true and reliable for such decision-making? And the answer to this question lies in the word called 'auditing'. Auditing plays an important role in opinion formulation on the part of the users.

Auditing is defined by professionals, academicians and experts as a work of examination and testing of accuracy of the books of accounts.

"Auditing is such an examination of the books, accounts and vouchers of business as will enable the auditor to satisfy that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business, and whether the profit and loss account gives a true and fair view of the profit and loss for the financial period according to the best of his information and the explanations given to him and as shown by the books; and if not, in what respects he is not satisfied." -Spicer & Pegler

Auditing is, "A systematic examination of books and records of a business or other organizations in order to ascertain or verify and to report upon the facts regarding the financial operations and the results thereof." -Montgomery

Auditing is, "A systematic and independent examination of data, statements, records, operation and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the proposition before him for examination, collects evidence, evaluates the same, and on this basis formulates his judgment which is communicated through his audit report."

- The Institute of Chartered Accountant of India

Value Addition 1: Did You Know?
Difference between Compilation, Review and Audit
Click on the link below to view a comparative table showing the difference between compilation, review and audit.
Source: http://www.mediacpas.com/Portals/288657/images/rca_chart1.gif

From the above definitions, the following points may be highlighted about auditing:

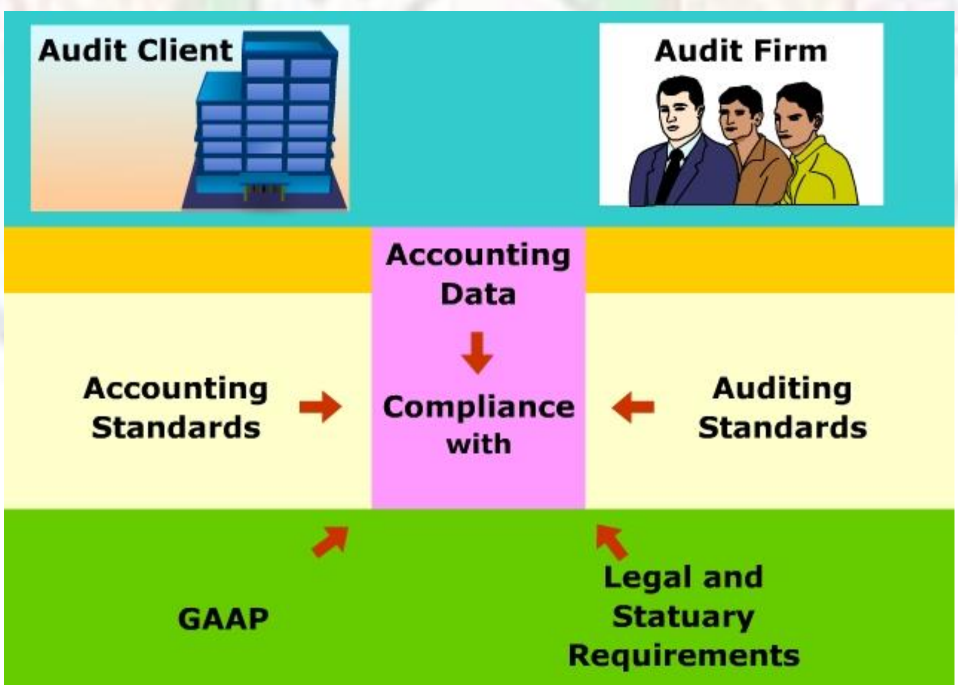
- Books of accounts and financial statements- Auditing is an extensive study of the books of accounts and the financial statements of the organization that gives reliability to such accounts and statements.
- Figures are Facts- Auditing primarily deals with verifying the arithmetical accuracy and correctness of transactions entered in the books of accounts. This is

accomplished through various methods like- inspecting, comparing, and checking to ensure that figures are a factual representation indeed.

- A systematic and critical examination- The examination of the books of accounts needs to be systematic and critical to give enough confidence to the investors, creditors, bankers, governments, and owners or shareholders.
- Conducted by an independent person or body- The process of examination of financial records and statements critically and its in depth study is done by an independent person or body. Independence of the person(s) conducting audit is a prerequisite to assure that the person(s) is free from any bias and will therefore be able to give a true and uninfluenced reporting of the accounts. It is the impartial examination that grants authenticity to the auditor's report.
- An opinion is formed- The auditor(s) on the basis of a critical examination of the books of accounts and related information form an opinion with regard to its accuracy, and whether or not the financial statements represent a true and fair view.
- Auditor's report- The auditor(s) finally expresses his opinion in the form of a report that is prepared by him and presented to the users. The report depicts information regarding the data collected and records procured for examination, process of auditing and verification, and the opinion with respect to truthfulness, fairness and authenticity of financial records. It must however be remembered that the auditor's report contains an opinion and is not a certificate with respect to the authenticity of financial data.

The figure below describes that the organization, which is the audit client is subject to scrutiny by the auditor or a group of auditors in the capacity of an audit firm. Such an auditor or audit firm, in its independent capacity, examines accounting data with respect to compliance with various standards, policies, and legal requirements.

Figure 2: Audit- Verification of Compliance



Qualities of An Auditor

An auditor's task is of such nature that innumerable people rely on their work. An auditor is therefore expected to possess certain personal traits that qualify him to take up such a task of responsibility and importance. The following qualities are desired in a person to act as an auditor.

1. Integrity – An auditor should be honest, sincere and straightforward while performing his professional duties.

2. Objectivity - He must adopt unbiased and impersonal approach to his work.

3. Independence- He should not subordinate his judgment to the will of others. He should be free of any interest apparently as well as in reality. He should audit the financial statements prepared by the management in unbiased way.

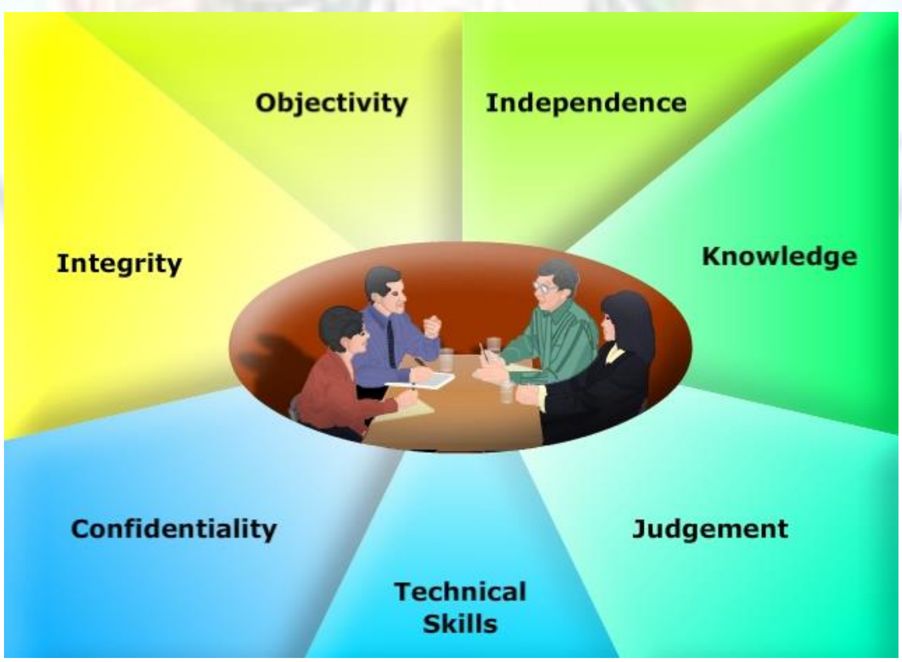
4. Knowledge- He should have general knowledge of the client's business, and business and economic trends in the industry. Awareness about certain laws like Taxation laws, Contract act, Partnership Act, Companies Act etc., is also required.

5. Judgment – He should be capable of taking firm judgment as to what items are to be checked and what should be the sample size.

6. Technical skills- He should be well versed with accounting and auditing processes and standards. Moreover, he should be aware of latest developments in auditing standards so that he can perform audit in effective manner.

7. Confidentiality- He should not disclose any confidential information acquired during the conduct of his professional duties to any third party, except when permitted by client or required by law.

Figure 3: Qualities of an Auditor



Value Addition: Example
Governance of HCL
Click on the link below to view an image that shows that for proper and transparent governance HCL adheres to SEBI guidelines, has an audit committee of Independent directors that conducts internal audit and facilitate the work of statutory audit.
Source: http://www.hcltech.com/about-us/corporate-governance

4. Advantages and Limitations of Auditing

There is an upside and a downside of everything. Auditing may be considered as a branch of study, a field of discipline, or an area of practice. It has a number of benefits to be offered to the management of the client organization, to the owners, government, employees and other outside stakeholders like investors, financial institutions, etc. At the same time, it is not free from the negative side. The drawbacks or limitations of auditing must be well known by the users before they rely on the auditor's report and base their decisions on it. The section below describes the advantages and the disadvantages of auditing.

Advantages:

In today's world auditing is an indispensible function which cannot be avoided for its advantages and the statutory requirement. The audit provides the authenticity to the financial statements, supportive documents, valuation of assets and the accounting system. Thereby, it also facilitates settling of disputes within the business and against the third parties. Thus, it is advantageous to all those who use the financial statements.

For Management: The auditor may suggest some systems of internal checks and controls to facilitate management in preventing errors and frauds. The management is able to get the independent and expert opinion with regard to the systems, financial statements and business conditions. It enables the management to make its employees work in a proper and accurate manner and to avoid the losses. It assists the management in the following ways:

- It helps in detecting and preventing errors and frauds.
- It keeps a moral check on the staff, so they remain vigilant while preparing books of accounts.
- It helps in making assessment of financial statements over the years because audited accounts are prepared uniformly.
- It helps in reviewing the system of internal control and internal check if required.
- Loans can be easily raised from banks/financial institutions as the creditors accept audited accounts as a true reflection of the state of affairs of the business.
- Insurance claims related to business are also settled easily with the help of audited accounts.

For the Owners

- On the basis of audited accounts, the sole trader can value his business for the purpose of sale of business or conversion to a partnership business by admitting a partner.
- A partner can value his business for the purpose of sale of business or for admission of new partner.
- It helps the partnership firms to value goodwill of the business on admission and retirement of partner.
- In case of a company form of organization, it helps the shareholders to judge the performance of management from audited accounts, as they do not know day-to-day administration of company.
- It also adds to their confidence about the state of affairs and statements thus ensuring protection of their rights.
- It helps in the valuation of shares.
- It keeps a check upon the management (inclusive of directors) against the commitment of fraud.

For the Government Bodies

- It helps the taxation authorities in the assessment of income tax, sales tax and wealth tax liability of the business.
- It helps the government while granting subsidies.
- Audited accounts serve as evidence and can be produced before the court of law.
- The government can get the wholesome view of the economic conditions of the companies and in turn for the whole economy through the audited statements of the major and key enterprises.

For Employees

- It discourages them from committing frauds as it acts as a moral check on them.
- They can judge reasonableness of payments with respect to salary, bonus etc.

Limitations:

Although auditing has a number of limitations, nevertheless the limitations of auditing does not undermine its significance in any way. Some of the limitations of auditing are listed below.

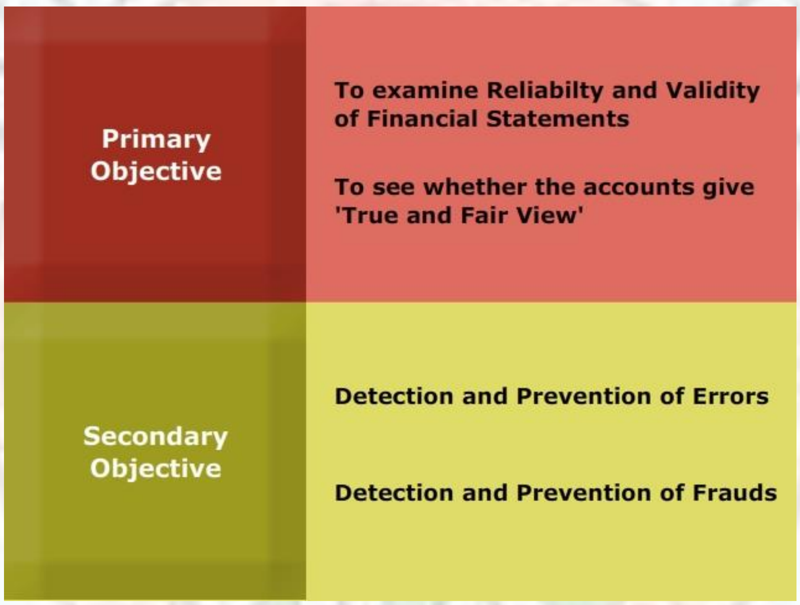
- There lies an inherent risk in audit. The auditor's report depends upon the accuracy of the explanations and information given by the client. Wrong information or misstatements affects the auditor's report.
- Auditing can turn out be a costly affair for some of the companies, especially the ones that are small in size.
- Auditing is often regarded as a useless activity. Some of the critics call auditing as a postmortem activity. It is argued that there is no use of such examination when events have already taken place.
- In some areas where auditor is not an expert, an auditor relies on the certificates issued by engineers, architects, managers etc., which may not always be correct.

The case of 'Westminster road construction and engineering co. (1932)' that is referenced later in the lesson, throws more light on this aspect.

5. Objectives of Auditing

The main objective of an independent financial audit is to determine whether financial statements reflect a true and fair view of the actual financial position of the company. The auditor's main objective is to independently review financial statements and express an opinion about their reliability in representing the company's financial position and working results. The adequacy and suitability of the accounting system is also judged through the auditing procedures by the auditor.

Figure 4: Objectives of Auditing



The audit of accounts is basically done for checking the accuracy, authenticity, completeness, so that it may be said that they represent a true and fair picture. The reasons for which an audit is conducted are termed as its objectives. These objectives of auditing can be categorized into two classes, namely primary objective and secondary objective. The primary objective as the name suggests is the basic purpose for auditing, while the secondary objective is only an incidental objective to the primary objective and not the main purpose of conducting audit. However, the importance of the secondary objective of audit cannot be undermined, and achieving it becomes necessary for achieving the primary objective.

1. Primary objectives- The main objective for which audit is carried out is to examine the reliability and validity of documents and financial statements and to express an opinion whether they give a 'True and fair view'. Explanation of the term 'True and Fair View'
2. Secondary objectives- An auditor can express his opinion regarding the truth and fairness of accounts only if such accounts are based upon statements that are free from errors and fraudulent misrepresentations. Therefore, the secondary objective,

which is also incidental to primary objective, is 'Prevention and Detection of Errors and Frauds'.

In order to clearly understand the above objectives it is important to understand the meaning of the terms 'True and Fair View', 'Errors', and 'Frauds'.

Value Addition: Surf and Learn
True and Fair View
Click on the link below to read about the meaning of the terms 'True' and 'Fair' in the context of auditing; and its importance in the audit reporting.
Source: http://accounting-simplified.com/audit/concepts/true-and-fair-view

6. Errors and Frauds

In the context of auditing, the term error refers to unintentional mistakes in collating financial information. The errors or mistakes which are committed in journal, ledger and any financial statement are known as errors.

Kholer's Dictionary for Accountants defines frauds as "The practices of deception or artifice with the intention of cheating or injuring another."

While both errors and frauds lead to distortion of financial information, the difference between an error and fraud is that while an error is unintentional, a fraud is intentional. Let us examine the types of errors and frauds likely to be found in the process of auditing.

Errors in Auditing

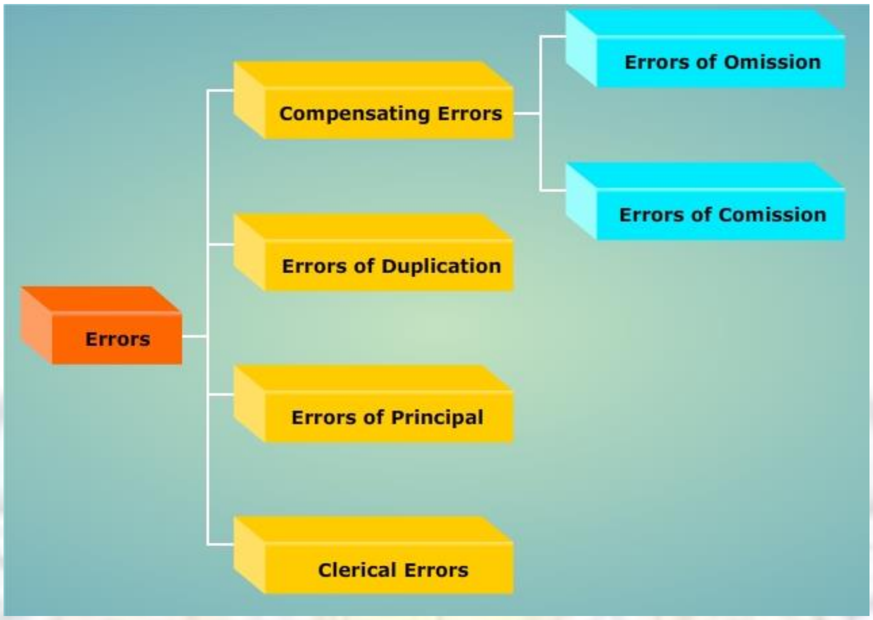
The different types of errors that are committed in the course of preparation of financial statements may be classified as under:-

1) **Clerical Error**- The errors that are committed while recording, totaling, posting and balancing of accounts are referred to as clerical errors. There are two types' of clerical errors:-
    a) Errors of Omission- These are the errors that occur due to non-recording of certain transaction either wholly or partially in the books of accounts.
    Example- Some vouchers may not be recorded at all. This will lead to complete omission of an entry. Or good purchased from Y may be recorded in purchase journal but not posted in ledger account of Y. This will lead to partial omission of this transaction. The partial omissions can affect the trial balance and thus can be detected but total omission needs to be detected very carefully.

    b) Errors of Commission- The errors that arise due to wrong posting for instance, posting on the wrong side of the account, incorrect balancing, posting in wrong account, posting of wrong amount or carrying forward wrong totals to trial balance etc. are called Errors of commission.
    Example- Sales of Rs. 3000 recorded as Rs 300 in sales book.
    Or debit balance of an account carried forward to credit side of trial balance.
    Such errors of commission can be detected by careful examination of the trial balance.
2) **Errors of Principles-**These errors arise when transactions are not recorded according to accounting standards laid down for preparation of financial statements. For example, when purchase of an asset is considered as purchase of goods or vice versa, or wrong valuation of assets, etc.

3) **Errors of Duplication-** Errors occurring due to a transaction which is recorded twice in the books of accounts is known as errors of duplication. For example, salary paid recorded twice in the books.
4) **Errors of Compensation-** These are two errors occurring simultaneously in such a way that their effect is counter balanced by each other and hence they do not show any effect on trial balance. For example, if a person A was paid Rs. 1000 but it is recorded as Rs. 100 on credit side of cash account and similarly, if a person B was paid Rs. 100 but the payment was recorded as Rs. 1000 on credit side of cash account, the effect of this transactions will be compensated totally.

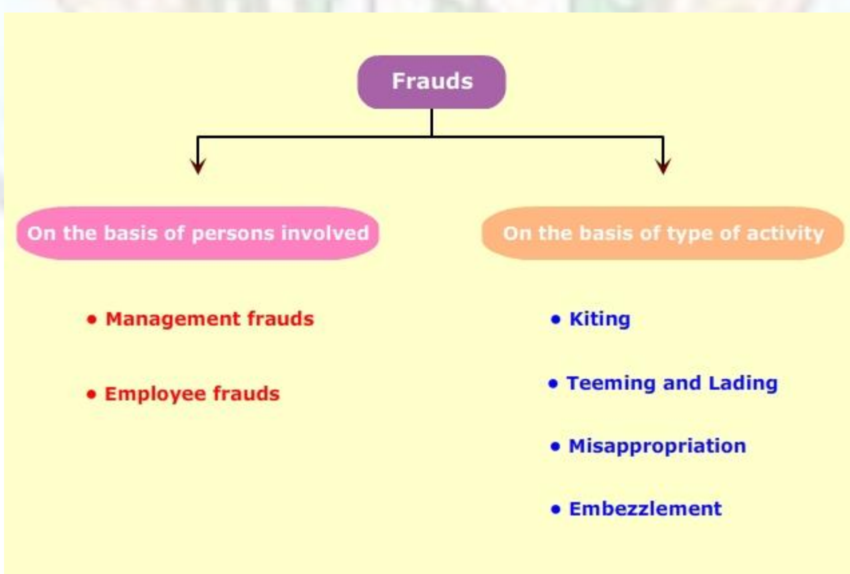
Figure 5: Types of Errors



Frauds in Auditing

A fraud is an act that is done intentionally. In the context of auditing it refers to misrepresentation of facts, concealment of facts or non-disclosure of vital information. It is primarily done with the objective/intention of either gaining personal advantage or with the objective of cheating others resulting in loss of other people's money and resources. Fraud is a criminal offence in India and is a punishable offence under Indian Penal Code. Fraud can be broadly classified under two heads, as shown in the figure below.

Figure 6: Frauds in Auditing



Frauds on the Basis of Persons Involved

Frauds are termed as management frauds or employee frauds based on the section or category of people involved in committing fraud.

a. Management Frauds These are the frauds that are committed by the owners of the organization or management. They may be of varied types. Some of them are listed as under:

- Showing personal expenditure as business expenditure,
- Window dressing of financial statements,
- Showing capital expenditure as revenue expenditure,
- Not recording some of the transactions in order to avoid taxes,
- Misappropriations of shareholders funds for personal benefits,
- Showing false transactions that never happened in reality in financial statements and using the money for personal benefits, etc.

b. Employee Frauds

Frauds committed by the employees of the organization generally involve: -

- Recording transactions by overstating expenses in order to misappropriate cash,
- Making forged vouchers,
- Using methods such as teeming and lading,
- Making entries in fictitious names, and
- Making incorrect writing offs of credit entries in the books of accounts.

Frauds on the Basis of Activities

1. Teeming and lading (also known as short banking)- Under this method, deficiency of cash is tried to be concealed for some time. For example when cash is received from a debtor A, it is not recorded in the cash books and is instead misappropriated. Later, when cash is received from some other debtor say B, his account is not credited, but the account of the first debtor is credited and cash is debited. Again later on, when cash is received from yet another debtor, his account is not credited, rather the account of the second debtor, i.e. B is credited, and cash is debited.

   This process goes on until the fraud is discovered.
2. Kiting- It is a fraud committed by taking advantage of the process of 'float'.
3. Misappropriation and Embezzlement- It means illegally using funds or property of some other person for personal benefit.

Value Addition: Explore yourself
Auditor Position vis-à-vis Errors and Fraud
Visit the site of Institute of Chartered Accountants India and explore **SA -240** on **professional aspect** of auditing in this regard to get an insight of auditors liability.

6. Auditor's Position vis-à-vis Errors and Frauds

The primary objective of an auditor is to critically examine the books and accounts to express his opinion regarding 'true and fair view' of the financial statements and in doing so he should take all necessary steps to prevent and detect frauds and errors. But still there is a possibility that a fraud may get detected later. Would that mean that the auditor did not do his/her duty responsibly? What would be the liability of an

auditor with regard to such errors and frauds that are detected after the auditing is complete?
The answer to it can be sought after reading two leading cases:

Kingston Cotton Mills Co. Ltd. Case (1896)
In this case, the company paid dividends in excess by showing overstated value of stocks. The valuation of stock was done by the manger and was certified. The auditors relied on the manager's certificate and did not check its authenticity. It led to payment of dividend out of capital. Had the auditor examined the books carefully, this fraud could have been detected. But it was held that, **'An auditor is a watchdog not a bloodhound'**.
An auditor is an expert person and he is expected to apply reasonable skill and care while expressing his opinion regarding the accounts of the company. He need not carry out his work with a suspicious mind, as he is not a bloodhound. As a watchdog, he is merely required to watch that the interests of stakeholders is protected and financial information has been drawn with care and compliance to required standards and laws. He is justified in relying on the certification made by the employees of the organization or the experts hired for matters like valuation of stock and other things. He may not probe into the authenticity of such documents and need not distrust the integrity of people involved in its preparation. He was absolved of any liability in this case, and it was established that he is justified to accept any document or certificate on its primafacie evidence. He may not look into its conclusive evidence.
Later, however, the scope of auditor's responsibility has been expanded.

Value Addition: Surf and Learn
Application of Judgment in Kingston Cotton Mills Co. Ltd. case in other cases
Click on the link below to go to links that describe the issues of companies related to the above case where the judgment was made in the light of judgment in the Kingston Cotton Mills Co. Ltd. Case. The link clearly reveals that Kingston Cotton Mills Co. Ltd. Case has been considered as a reference point or a leading case for deciding various other related cases.
Source: http://www.indiankanoon.org/search/?formInput=in%20re%20kingston%20cotton%20mills

Westminster Road Construction and Engineering Co.
The above case also related to overvaluation of work-in-progress. In this case, it was held that auditor is a skilled professional and he should have taken reasonable care and should have critically examined the books of accounts, and hence auditor was held responsible for negligence in the matter of detecting such overvaluation.

The auditors' liabilities have undergone many changes from time to time, and the auditors now are expected to follow various audit procedures in order to obtain sufficient and appropriate audit evidence before forming any opinion about the financial statements.

Value Addition: Surf and Learn
Liabilities of an Auditor
Click on the link below to view various liabilities of an Auditor.
Source: http://studypoints.blogspot.in/2011/11/discuss-in-details-liabilities-of_2717.html

7. Classification of Audit

Liberalization and rapid growth has led to increased competition resulting into intense focus of organizations on expansion and diversification. This, in turn, has resulted into a complex maze of activities performed by organizations. Thus, it has led to audit of various types of activities in order to detect and improve them and thereby facilitate survival in this tough competition.

The types of audits can be classified in number of ways. The most popular categorization is on the basis of:

Figure 7: Types of Audit

Basis	Description
Organisational Structure	· Private Audit · Governament Audit · Statutory audit
Specific Objectives	· Internal audit · Independent financial audit · Cost audit · Mnagement Audit · Tax Audit · Social Audit · Envoirnmental Audit · Performancy audit or perfromance-cum-efficiency audit
Taking time as the base	· Continous Audit · Interim Audit · Annual Audit · Balance Sheet Audit
Audit based on the scope of work	· Complete Audit · Partial Audit · Detailed Audit

A) Organization Structure

1. Statutory Audit- It is an audit that is compulsorily prescribed by some statute or a law. The scope of activities, rights, duties, qualification, disqualifications, remuneration of auditors are all prescribed and laid down as per the statutes. The scope of its activities is also laid down. A statutory audit is a complete audit and not a partial audit, as it incorporates everything in detail and includes each and every aspect.
2. Private Audit- This type of audit is not compulsory audit. It is an optional form of audit which is conducted on the desire of the proprietors to check the accuracy of their financial statements.
3. Government Audit- It is an audit of expenditure and receipts of government transactions to judge the degree of compliance of accounting policies and standards in government administration, departments and corporations. It is a compulsory audit for public sector companies. The Comptroller and Auditor General (CAG) is appointed by the Central Government.

Value Addition: Image
Difference between Private Audit & Statutory Audit
Click on the link below to read about the difference between a private and statutory audit.
Source: http://dialogue.hubpages.com/hub/Private-Audit-and-Statutory-Audit

B) Specific Objective

1. Internal Audit- According to Howard F. Stettler, "Internal audit is the audit of company affairs and activities from within." It is an audit that is conducted by the organization itself to appraise the services and responsibilities undertaken.

Value Addition: Image
Internal Audit Process
Click on the link below to view an image on internal audit process.
Source: http://www.astafinancial.com/wp-content/uploads/2011/10/external-auditors.gif

2. Independent Financial Audit- It is an independent audit conducted by auditors from outside, with an objective of finding out the true and fair view of financial aspects of the company regarding its operations, activities and position of the company financially.
3. Cost Audit- This is a specialized form of audit in which the cost records are examined with the objective of finding the degree of accuracy and compliance of cost accounting systems in the organization.
4. Management Audit- This type of audit focuses upon management as a whole comprising of its plans and organizational functions, activities undertaken and management decisions.
5. Tax Audit- The basic aim of this audit is to verify whether the total taxable profits of a company are calculated properly so that the tax liability therein is ascertained accurately.
6. Social Audit- This type of audit is new branch in auditing. It was first conducted by TISCO in 1980. When a company realizes that its existence is not just to utilize the resources of the nation and earn profits, but also to contribute towards nation by taking its social responsibility, then the company is said to be socially aware. The audit of performance and impact of social activities undertaken by a company is known as social audit.
7. Environment Audit- It is conducted by companies to assess the company's efforts in protecting its environment. This kind of audit is applicable to industries that come under Environment (Protection) Act, 1986.
8. Efficiency-cum-Performance Audit (EPA)- This audit focuses to assess the efficiency, economy and effectiveness of a company in delivering its final output. It focuses on assessing on its capacity utilization, resources utilization and goal achievements.

C) Scope of Work

1. Complete Audit- In this audit, an auditor's scope of work covers checking of all the transactions, including all the totals, all the accounts on the basis of documentary evidence.
2. Partial Audit- At times an audit is required to assess only some books of account or books pertaining to only a part of the accounting year. Such kind of audit is called partial audit.
3. Detailed Audit- As the name suggests, this type of audit focuses on all transactions. It is quiet similar to a complete audit, but in this kind of audit, the scope of examining certain transactions is much more detailed.

D) Time at which Audit is Conducted

1. Continuous Audit- Under this type of audit, auditors are continually engaged in auditing company's accounts throughout the year to check its state of affairs, or auditors keep auditing the company accounts at regular and frequent intervals throughout the year.
2. Annual Audit- Under this type of audit, an audit is undertaken or conducted at the end of accounting period or financial period.
3. Interim Audit- This type of audit is done in between two annual audits to assess the interim profits of the company, when it is planning to declare interim dividends.
4. Balance Sheet Audit- This type of audit is conducted at the time when balance sheet is drawn up, generally at the end of the year. This is a limited type of audit which focuses on the items of balance sheet on both assets and liabilities side.

Summary:

- Audit is an examination of all the financial statements of an organization with the objective to express opinion regarding truthfulness and fairness of financial records on the basis of their reliability, accuracy, authenticity and validity.
- The secondary objective of audit comprises of prevention and detection of errors and frauds.
- Due to specialized areas in an organization an audit can be of different types. The basis of classification can be organizational, scope, time period and specific objective.
- An audit is therefore an important filed of study that cannot be ignored in today's time.
- People invest money in the stocks of the company relying on the accounts so presented.
- If these accounts are not true and fair it will result in loss of money of lots of stakeholders. Therefore, one cannot underestimate the importance of auditing. It plays a crucial role in capital formation of an economy. Its presence makes saving function safer and more efficient.

Glossary:

- **AICPA or American Institute of Certified Public Accountants:** The professional organization of CPAs in the U.S. It is a private organization of CPAs, not an arm of the government. Each state issues CPA certificates, not the AICPA. Since each state makes its own laws, each state could prepare and grade their own CPA examination. However, each state uses the uniform CPA exam prepared and graded by the AICPA.
- **Auditor's Independence:** It refers to independence of an auditor from the management of the company. It means an auditor opinion should be free from all kinds of bias and should not be deviated by any pressure or directions of the management
- **GAAP or Generally Accepted Accounting Principles:** According to Rule 203 of the AICPA Code of Professional Conduct, GAAP for nongovernment entities include (in a conflict the source earlier in the list prevails): 1. FASB Statements and Interpretations, APB Opinions, ARBs. 2. FASB Technical Bulletins, AICPA Guides and AICPA Statements of Position. 3. Positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins. 4. AICPA accounting interpretations, FASB staff "Qs and As", and widely recognized industry practices. 5. FASB Concepts Statements, textbooks, articles.
- **GAAS or Generally Accepted Auditing Standards:** The ten auditing standards adopted by the membership of the AICPA. Auditing standards differ from audit procedures in that "procedures" relate to acts to be performed, whereas "standards" deal with measures of the quality of the performance of those acts and objectives of the procedures.
- **Kiting**- drawing/writing a bank cheque on insufficient funds to take advantage of time required for collection of cheques.
- **Opinion**- a conclusion held with confidence but not substantiated by knowledge or proof.
- **Paying Dividends out of Capital**: Dividends are paid when there is adequate profit. Paying dividends when profits are not sufficient, such that the capital of the company diminishes amounts to paying dividend out of capital.
- **Window dressing**- it is wrong or false representation of accounts of a organization with a view to depict a positive but false picture of financial

position of company than it is in reality. This is done through adopting inappropriate accounting policies and principles of accounting.

Exercises:

A. Objective Type Questions

State True or False:

1. Being a practical discipline, auditing does not require an underlying theory.
2. In all auditing situations, the only evidence available is books and vouchers
3. An independent financial auditor should evaluate the internal control system relating to all functions
4. Detection risk can be reduced if an auditor carries out effective analytical procedures.
5. Due to cost considerations, no internal control system can completely prevent occurrence of fraud and error.

Fill in the blanks

1. An audit in which the auditor examines the financial statements of an enterprise to express an opinion as to whether or not they reflect a true and fair view of its state of affairs and working results is known as ……
2. An audit in which auditor reviews the performance of the various segments of an enterprise is called……
3. An audit in which the auditor examines compliance with certain provisions of income tax act/ rules is called……
4 An audit in which auditor expresses an opinion on cost statements is known as……..

B. Short Questions

1. What does the term auditing means and what are its objectives?
2. Comment "an auditor is a watchdog not a blood hound".
3. Write a short note on social audit

C. Long Questions

1. Describe in detail the main classes of errors and frauds and auditors duty with regards to errors and frauds
2. Describe in details various kinds of audit.

Answers to Objective Type Questions:

1. False
2. False
3. False
4. True

5. True

Fill in the blanks: 1. Independent financial audit 2. Performance audit
3. Tax audit, and 4. Cost audit

References:

1. Work Cited and Suggested Readings:

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- K.C. Shekhar, Auditing, Vikas Publishing House (P) Ltd.
- S. D. Sharma, Auditing Principles and Practice, Taxmann Allied Services (P) Ltd.
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- Pagare, Dinkar., "Principles and Practice of Auditing", Sultan Chand and Sons, New Delhi.
- Institute of Chartered Accountants of India, ''Auditing and Assurance Standards'', ICAI, New Delhi.
- Singh, A.K. and Gupta, Lovleen, Principles of Auditing, Mayur paperbacks, New Delhi.
- www.icai.org auditing as a filed in india
- www.theiia.org to know more about internal auditors

2. Web Links:

- Visit the link http://www.drlillie.com/a541/pics/audit%20tests.jpg to view an image on five types of audit tests to gather evidence.
- Visit the link http://www.actionfraud.police.uk/fraud_protection/asset_misappropriation to read on misappropriation of assets.
- Visit the link http://www.envoynews.com/rwcpas/e_article000990340.cfm to read on embezzlement of assets.
- Visit the link http://www.preservearticles.com/201104065044/what-are-the-duties-assigned-to-a-company-auditor.html to read about the auditor's duties.
- Visit the link http://bilaras.hubpages.com/hub/NATURE-PURPOSE-AND-SCOPE-OF-AUDIT-AND-REVIEW to read about nature, purpose and scope of audit.
- Visit the link http://www.cag.gov.in/html/unionaudit.htm to know about the Comptroller and Auditor General of India.