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-Author-

CA. Sarthak Niraj Jain

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Chapter 01 NATURE, OBJECTIVE AND SCOPE OF AUDIT

1 ORIGIN OF AUDITING

01 **Kautilya's Arthshastra (4th century BC)** - Reference to auditing is found where it talks about fixed accounting year, a process for closure of accounts and audit for the same. Even there are references to misstatements in financial statements (FS) due to abuse of power.

02 **Origin of word "AUDIT"** (Medieval times – 1100 to 1500 AD)
Auditors used to hear the accounts read out to them to check that employees were not careless and negligent. This lead to use of word audit originating from Latin word "audire" meaning "to hear".

03 **Industrial revolution in Europe** (Late 18th / Early 19th Century)
Led to astronomical expansion in volume of trade and consequently demand of auditors.

04 **Auditor of Government Entities in India** (1860)
The first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India (C&AG) is an independent constitutional authority responsible for auditing government receipts and expenditures.

05 **Institute of Chartered Accountants of India** (1949)
It was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

2 MEANING AND NATURE OF AUDITING

"An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

Analysis

A Audit is an independent examination of financial information

- Meaning of Independence - Judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
- The auditor should be independent of entity under audit to form opinion without any influence.
- Independence increases its ability to act objectively without any biases.
- Example, Auditor appointed by a company which is owned managed by his brother or company where he has invested in shares of the company, auditor should not accept as his own self-interest gets involved.

B Audit can be of entity that is a

- Business or a non-profit organization like an NGO or a charitable trust.
- Small, medium or large organisation.
- Any entity with any legal structure i.e. proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.

C The purpose of audit is to express an opinion on the FS.

- Preparation and presentation of FS of an entity is responsibility of management.
- The auditor expresses an opinion on FS by means of written audit report.

D Auditor to check that FS are not misleading anybody

He ensures that – (FS as per books → Supported by evidences → Nothing Omit → Clearly → Class, disclosure, description as per AS → T&F View)

- the accounts have been drawn up with reference to entries in the books of account;
- the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- none of the entries in the books of account has been omitted in the process of compilation;
- the information conveyed by the statements is clear and unambiguous;
- FS amounts are properly classified, described and disclosed in conformity with accounting standards; and
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Auditing provides assurance. Its basic nature lies in providing assurance to users - providing confidence to users of FS. Such an assurance lends credibility to FS.

3 AUDITING- RELATIONSHIP WITH OTHER DISCIPLINES

Auditing is interdisciplinary in nature and draws as well as make use of different subjects. An auditor is required to have sound understanding of:

Accounting → Auditing reviews the FS which are nothing but a result of the overall accounting process hence a sound knowledge of accounting principles is required.

Law → An auditor should have a good knowledge of business laws and taxation laws affecting the entity.

Economics → Auditor is expected to be familiar with the overall economic environment of the client in which the business is operating.

Behavioural Science → Knowledge of human behaviour as auditor has to interact with people for seeking information and making inquiries.

Statistics → Knowledge of statistical sampling for meaningful conclusions. Auditors uses statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction. So, use of statistical methods to draw samples for conducting audit is made.

Financial Management → Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. These also assist in applying some audit procedures effectively. Knowledge of financial market is also expected from auditor.

Mathematics → For verification of inventories and other checks.

Data Processing → EDP auditing in itself is developing as a discipline in itself.

Production → Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

4 OBJECTIVES OF AUDIT

SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing"

In conducting audit of FS, objectives of auditor are: -

(a) To obtain reasonable assurance about whether the FS as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the FS are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the FS, and communicate as required by the SAs, in accordance with the auditor's findings.

Analysis

- **Reasonable assurance** is to be distinguished from absolute assurance.
  Absolute assurance is a complete assurance or a guarantee that FS are free from material misstatements.
  However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.
- Audit is carried out with professional competence and skills in accordance with **Standards on Auditing**.
  Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated.
  On basis of that, conclusions are drawn and opinion is formed.
  It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.
- **Misstatements in FS can occur due to fraud or error or both**
  The auditor seeks to obtain reasonable assurance whether FS as a whole are free from material misstatements caused by fraud or error.
  He has to see effect of misstatements on FS as a whole, in totality.
- **Opinion - FS as per applicable FRFW**
  Obtaining reasonable assurance that FS as a whole are free from material misstatements enables the auditor to express an opinion on whether the FS are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- **Audit Report – As per findings**
  The opinion is reported and communicated in accordance with audit findings through a written report as required by SAs.

5 SCOPE OF AUDIT

(Scope refers to range or reach of something)

Purpose of an audit
To enhance the degree of confidence of intended users in the FS. It is achieved by the expression of an opinion by the auditor on whether the FS are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Users of FS
May be shareholders, employees, customers, government and regulatory authorities, bankers etc.

Applicable financial reporting framework
Framework adopted in the preparation and presentation of the FS, acceptable in view of the nature of the entity and the objective of the FS, or that is required by law or regulation.
Example, in case of companies in India, financial reporting framework is provided under Schedule III of Companies Act,2013.

A SCOPE OF AUDIT- WHAT IT INCLUDES

Scope of audit of FS:

(1) **Coverage of all aspects of entity**
All aspects of the entity relevant to the FS being audited are covered under audit.

(2) **Reliability and sufficiency of financial information**
By study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures auditor verifies information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of FS.

(3) **Proper disclosure of financial information**
FS should properly summarize transactions and events recorded therein. FS to consider the judgments made by management in preparation of FS. For example, choosing of appropriate accounting policies in relation to various accounting issues like choosing method for valuation of inventories.

(4) **Expression of Opinion on historical financial information**
Auditor evaluates selection and consistent application of accounting policies by

management. FS of an entity are prepared on historical financial information basis hence audit is also based on historical financial information.

"Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

B SCOPE OF AUDIT- WHAT IT DOES NOT INCLUDES

- Responsibility of preparation and presentation of FS – Lies with Management
- Duties outside scope of competence of auditor - Auditor is not expected to perform duties which fall outside domain of his competence, like:
  - Physical condition of certain assets like that of sophisticated machinery
  - Suitability and life of civil structures like buildings
- Expertise in authentication of documents - The genuineness of documents cannot be authenticated by him because he is not an expert in this field.
- Investigation - Audit is distinct from investigation.

INVESTIGATION Vs AUDIT

- An audit is not an official investigation into alleged wrong doing.
- Auditors do not have any specific legal powers of search or recording statements of witness on oath necessary for carrying out an official investigation.
- Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
- The objective of audit, is to obtain reasonable assurance about whether the FS as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
- The scope of audit is general and broad whereas scope of investigation is specific and narrow

6 INHERENT LIMITATIONS OF AUDIT

Certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that FS are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors:

A Nature of financial reporting

- Preparation of FS involves making many **judgments** by management.
- Management prepared FS free from material misstatements and devises internal controls. Such **controls** also suffer from **own limitations** like lapse of control due to collusion of employees.

B Nature of Audit procedures

- The auditor carries out his work by obtaining audit evidence through performance of audit procedures.
- However, there are practical and legal limitations to obtain audit evidence like use of sample testing or sometimes management may not provide complete information as requested by auditor and auditor cannot force them, an example of legal limitation.
- The management may indulge in frauds and conceal it to make it hard to detect by the auditor. It may produce fabricated documents to auditor. An auditor may not be an expert to detect unauthenticated documents
- Entity may have entered into some transactions with related parties only paper and auditor may not be able to detect probable wrong doings in such transactions.

C Not in nature of investigation

- Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that FS are free from material misstatements due to frauds or errors.

D Timeliness of financial reporting and decrease in relevance of information over time

- The relevance of information decreases over time and auditors cannot verify each and every matter.

E Future events

The business may cease to exist in future due to changes in market conditions, emergence of new business models or products or due to onset of some adverse events.
In view of the above factors, an auditor cannot provide a guarantee that FS are free from material misstatements due to frauds or errors.

7 WHAT IS AN ENGAGEMENT?

- Engagement means an arrangement to do something.

- In audit, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services.
- It takes the shape of an engagement letter.

External audit engagements

The purpose of external audit engagements is to enhance the degree of confidence of intended users of FS. Such engagements are also reasonable assurance engagements. For example, in India, companies are required to get their annual accounts audited by an external auditor. Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.

8 BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?

- **Confidence to users** that information on which they are relying is qualitative and as per globally recognized Standards.
- **Shareholders interest is safeguarded** by an audit of FS prepared by management.
- **Moral check on employees** for the fear of discovering frauds by audit.
- Audited FS are helpful to government authorities for **determining tax liabilities**.
- Audited FS can be **relied upon by lenders, bankers** for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- An audit may also **detect fraud or error** or both.
- An audit reviews existence and operations of **controls** operating in any entity. Hence, it is useful at pointing out **deficiencies**.

9 AUDIT- MANDATORY OR VOLUNTARY?

Companies Act – Every company to get its accounts audited
IT Act – Audit needed if turnover crosses specified limits
School / Colleges, etc – Audit pre-requisite for availing grants from the Government.
Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

10 WHO APPOINTS AN AUDITOR?

Company - Appointed by members (shareholders) in Annual General Meeting (AGM).
Government companies - Appointed by C&AG, an independent constitutional authority.

Firm – Auditor is appointed by partners of firm.

Government Authority – Law may require to appoint auditor by government authorities.

11 TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The outcome of an audit is written audit report with his opinion. The report is submitted to **person making the appointment**.

Example: Companies – Shareholders; Firm – Partners who have engaged him.

12 ASSURANCE ENGAGEMENT

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

A Elements of an Assurance Engagement

Following elements comprise an assurance engagement: -

1. **Parties – 3 party – Practitioner, Responsible Party, and Intended Users**

A practitioner is a person who provides the assurance (could be auditor of historical financial information of report on prospective information).

A **responsible party** is the party responsible for preparation of subject matter.

Intended users are the persons for whom an assurance report is prepared.

2. **Subject matter**

It refers to the information to be examined by the practitioner. For example, financial information contained in FS while conducting audit of FS.

3. **Suitable criteria**

These **refer to benchmarks used** to evaluate the subject matter like standards, guidance, laws, rules and regulations.

4. **Sufficient appropriate evidence**

"Sufficient" – Quantity of evidence obtained by auditor.

"Appropriate" – Quality of evidence obtained by auditor.

One evidence may be providing more comfort to auditor than the other evidence.

The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.

5 **A written assurance report in appropriate form**

A written assurance report is the outcome of an assurance engagement.

B Meaning of Review; Audit Vs. Review

Audit is a reasonable assurance engagement. However, Review is a limited assurance engagement. It provides:

- lower level of assurance than audit, and
- is based on fewer procedures; and
- is useful for drawing limited conclusions.

Both are based on historical financial information.

C Types of Assurance Engagements- Reasonable assurance engagement vs. Limited assurance engagement

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides **high** level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	**Example** of limited assurance engagement is review engagement.

D Prospective financial information

"Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both.

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