# Chapter – 1 Nature Of Auditing

## Agenda of Chapter

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|---|---|
| 1. | Introduction |
| 2. | Meaning and Definition of Audit |
| 3. | Concept of FS |
| 4. | Auditor |
| 5. | Independent Audit |
| 6. | Objective of Audit |
| 7. | Causes and Nature of Errors and Frauds |
| 8. | Basic Principles Governing Audit |
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*Note* – 1. Students may note that Notes deals with various aspects of financial audit only unless otherwise specified.

2. SA's and SQC will be discussed separately and procedure of issuing SA by AASB and series of SAs, SRSs, SAEs, SREs, SQC.

## 1. Introduction

- No business can effectively carry its activities without the help of proper records and accounts. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of organization.

> *For E.g.* → Decisions based on wrong accounting statements may prove harmful or fatal to the business. As a result of the independent audit of an entity's financial statements is a vital service to investors, creditors and other participants in economic exchange.

- The statements of account are viewed by different interests from different angles; consequently the statements prepared primarily for the use of the owners may not be wholly useful to the other interests.
  - ✓ Separate statements of accounting highlighting the information needed by the interested parties, other than the owners cannot be expected to be prepared in the ordinary course unless the same is specially called for.
  - ✓ The auditor can accomplish this by a process of examination and appraisal.

**Did you know this?**

To correctly understand the role of auditing, you must understand the nature and purpose of the financial statements.

***'Financial statements'*** is a set of documents which show the result of business operation during a period - how the result was achieved and the position of assets and liabilities on the given date.

Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession.

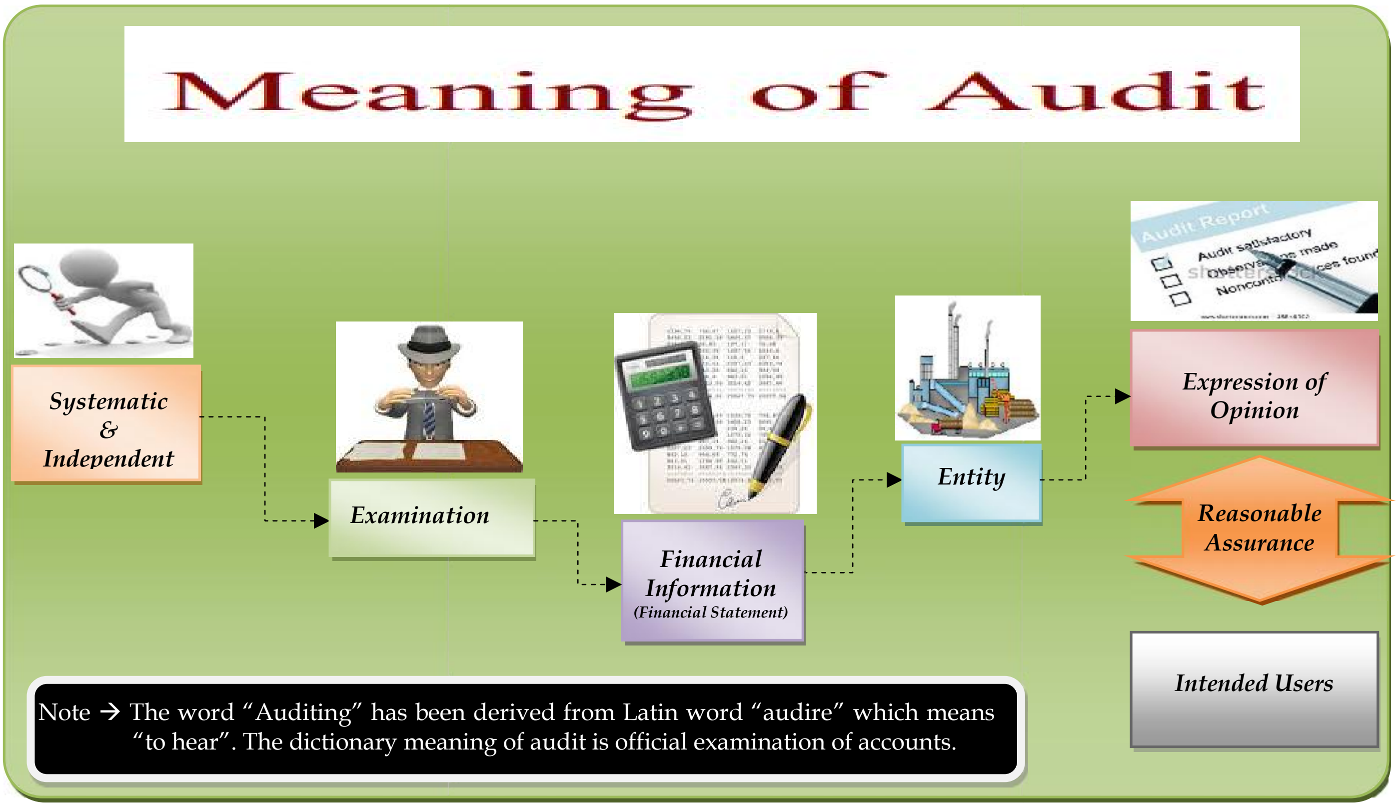
*(To be discussed more in detail later)*

**For Examples:-**

| S. N. | Viewer | Interest |
|---|---|---|
| 1. | Management | Management may need more detailed information on matters considered critical by it. |
| 2. | Investor and Financial Analysts | Investor and Analysts are keen to see the projected image of the Current state of affairs (Balance Sheet). |
| 3. | Government | Government would look for inadmissible items under the taxation laws, etc. |

## 2. Meaning and Definition of Auditing

### 2.1 Meaning of Audit




Note → The word "Auditing" has been derived from Latin word "audire" which means "to hear". The dictionary meaning of audit is official examination of accounts.

## 2.2 Definition of Audit

| S.N. | According to | Definition |
|---|---|---|
| **1.** | **General Guidelines on Internal Auditing issued by ICAI** | "Auditing is defined as a **systematic** and **independent examination** of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose".<br>Note → The aforesaid definition is very authoritative. It makes clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity. |
| **2.** | **ICAI (In SA- 200 old)** | "An audit is 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. |
| **Note** → In any auditing situation, the auditor perceives and recognizes the **propositions (a statement expressing a concept that can be true or fair)** before him for examination, collects evidence, evaluates the same and on this basis formulates this judgment which is communicated through his audit report. | | |

## 2.3. Features/ Characteristics of Audit

| S.N. | *Feature/Characteristics* | |
|---|---|---|
| **1.** | *Systematic & Independent* | Audit has to be conducted in proper way. Auditor should be Objective and not be influenced by the Client. |
| **2.** | *Financial Statements* | Auditor's opinion is on Financial Statements. The Preparation of Financial Statements is the responsibility of Management. |
| **3.** | *Entity* | Client can be in any legal form i.e. it may be in Partnership, Company, Prop., Trust, etc |
| **4.** | *Opinion* | His opinion is on 'True & Fair View' of Financial Statements. |

# 3. *Concept of Financial Statements*

As we have already discussed in the introduction about the Financial Statement. Now we are going to discussed component and user of FS.

| S.N. | Aspect | Description |
|---|---|---|
| **1.** | **Definition** | ☞ A **structured representation of historical financial information**, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.<br>☞ The term "financial statements" ordinarily refers to a **complete set of financial statements** as determined by the requirements of the **applicable financial reporting framework,** but can also refer to a single financial statement. |
| **2.** | **Complete Set of FS** | Generally, Financial Statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include –<br>1. A Balance Sheet,<br>2. Statement of Profit and Loss,<br>3. A Cash Flow Statement, and<br>4. Related Notes. |
| **3.** | **Single Financial Statement** | In certain Financial Reporting Frameworks, a single financial statement and the related notes might constitute a complete set of financial statements normally, **for e.g.** In Government Departments and local bodies; the primary financial statement is a statement of cash receipts and payments. |

| | | |
|---|---|---|
| **4.** | **Type of FS** | ***General/Special Purpose:*** The financial statements may be prepared in accordance with a financial reporting framework designed to meet – (i) The common financial information needs of a wide range of users (i.e., "general purpose financial statements"), or (ii) The financial information needs of specific users (i.e., "special purpose financial statements"). |
| | **5. Users of FS** | |
| **(a)** | **Owner** | ✓ For evaluating performance of business.<br>✓ For evaluating profitability of business. |
| **(b)** | **Management** | ✓ For evaluating their own performance.<br>✓ For making decisions.<br>✓ For judging tax liabilities.<br>✓ For estimating expected future outcomes.<br>✓ For day – to – day decisions. |
| **(c)** | **Lenders & Creditors** | ✓ For judging credit worthiness of the entity.<br>✓ For judging recoverability of their dues, Financial Position and Strength of the company. |
| **(d)** | **Customers** | ✓ For determining general consistency of the business. |
| **(e)** | **Government** | ✓ For calculation and collection of direct tax.<br>✓ For levying excise duty. VAT, etc.<br>✓ To evaluate performance and contribution to social objectives. |
| **(f)** | **Employees** | ✓ For determining reasonableness of wages & salaries.<br>✓ For creating demand for bonus and for other perks. |
| **(g)** | **Research analysts etc.** | ✓ For evaluating trends, study, research and analysis.<br>✓ For judging investment opportunities in the entity. |

## *4. Auditor*

| S.N. | Aspect | Description |
|---|---|---|
| **1.** | **Definition** | "Auditor" is used to refer to the **person or persons conducting the audit**, usually the engagement partner or other members of the engagement team, or, as applicable, the firm.<br><br>**Note** → Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant. |
| **2.** | **Work of Auditor** | ☞ He makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements.<br><br>☞ The ***opinion that he is called upon to express is whether the financial statement reflect a true and fair view.***<br><br>☞ Auditing, especially of companies and for public purposes has become the preserve of persons having recognised professional training and qualification. |
| **3.** | **Qualities** | ***1.*** As far as formal qualities are considered, an auditor has to ***have professional training and qualification.***<br><br>2. As per ***Dicksee***, the qualities required are *t*act, *d*iscretion, *g*ood temper, *i*ntegrity, *c*aution, *f*irmness, *i*ndustry, *r*eliability *j*udgment, *p*atience and *c*lear headedness.[TD GIC FIR JPC]<br><br>3. He must also have a ***shine (to be good) of culture*** for attaining great heights.<br><br>4. He must have the highest degree of ***integrity*** backed by adequate independence, ***Code of ethics*** mentions integrity, objectivity and independence as one of |

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|---|---|---|
| | | the ***fundamental principles*** of professional ethics.<br>5. He must have a thorough ***knowledge of the general principles of law*** which govern matters with which he is likely to be in intimate contact.<br>6. He should not only be equipped with a ***sufficient knowledge of conducting business*** but also an understanding of special features peculiar to particular business whose accounts are under audit.<br>7. He holds a position of ***trust***, hence must have basic human qualities.<br>8. An exhaustive ***knowledge of accounting*** in all its branches is the sine qua non (a thing which is absolutely essential) of auditing practice.<br>9. Both practical training and theoretical education are equally necessary for the development of ***Professional competence*** of an auditor for undertaking any kind of audit assignment. |
| **4** | **Which Professionals are in Position to Audit the A/c?** | ***Chartered Accountants*** are in a position to auditing of almost any accounting aspect. Auditors work, reporting on financial matters of business and other institutions, is set with the problems of human for the fallibility; errors and frauds are frequent. |
| **Did you Know This?** | | ***Lord Justice Lindley***<br>In the course of the judgment in the famous ***London & General Bank*** case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "An auditor must be ***honest*** that is, he must not certify what he does not believe to be true and must take ***reasonable care and skill*** before he believes that what he certifies is true". |
| **5** | **Classification of Auditor** | **Functional Classification Auditor –**<br>**(a) External**<br>✓ Practice the profession of accountancy on qualification and are external vis-a-vis to the organization of which they audit the accounts.<br>✓ They are appointed by the owners of the organization.<br>✓ When appointed under particular statute.<br>✓ They are independent **in relation to** the organization.<br>**(b) Internal**<br>✓ May be professionally qualified.<br>✓ They are appointed to perform specific work and are internal vis-a-vis to the organization and are thus is appointed by the management.<br>✓ They may be appointed either on contract basis or as employees to undertake auditing.<br>✓ They are not independent as they are appointed by management or audit committee.<br>✓ Their scope of work may extend beyond the financial accounting and may include cost investigation, inquiries relating to losses wastages, production audit, etc. |

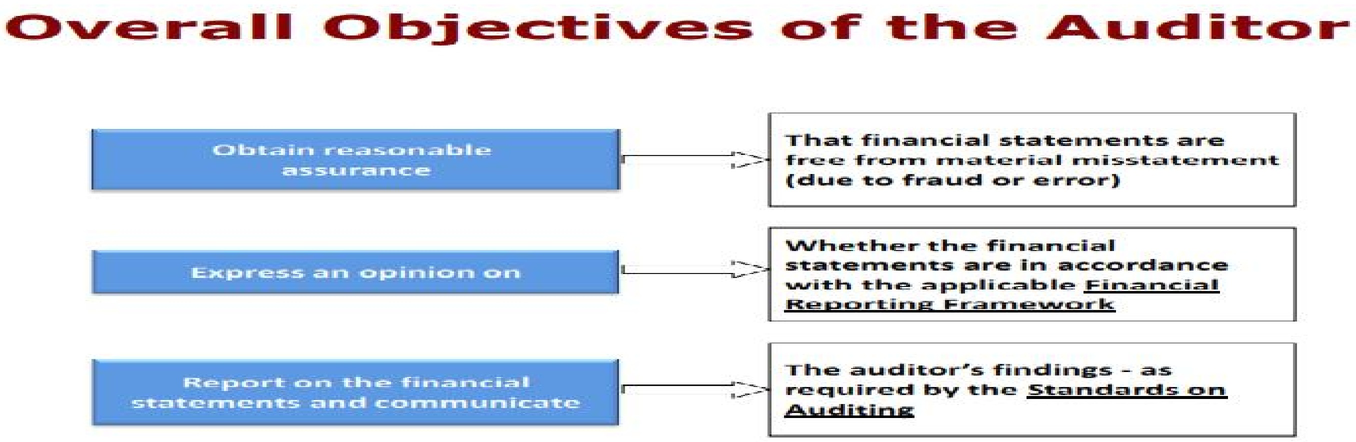
## 5. *Independent Audit*

The main aspect of the audit and the opinion of the auditor is that of reliability. Independence is the key – stone of any profession, especially of the accountancy profession. Many outside parties such government, investors, financial institutions rely on the opinion of an auditor.

| S.N. | Aspects | Description |
|---|---|---|
| **1.** | **Meaning** | It implies that a judgment of a person is not subordinate to the wishes or direction of another person, who has engaged him or to his own interest. |

| | | |
|---|---|---|
| **2.** | **For Auditor** | (a) *ICAI has already framed a proper code of ethics* and the same are enforced.<br>(b) The Companies Act, 1956/2013, in order to ensure independence has also made certain, provisions which prohibits or regulates the appointment of auditors.<br>**(c)** SA also provide about auditors independency. |
| **3.** | **Visibility** | ☞ Independence of an auditor must **not only exist but should also appear** to exist, to all reasonable persons.<br>☞ Independence is the ***strength of an individual and a condition of mind*** where an auditor has to adopt an unbiased view on the matters ***without a favour and fear.*** |
| **Did you Know This?** | | Mgt. is ***responsible for selecting accounting principles*** that appropriately reflect events that occur and for making other accounting estimates and judgments. This ***responsibility is not lessened*** by an independent audit. |
| | **3. Advantages** | |
| **(a)** | **Safeguards the Financial Interest** | It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders. |
| **(b)** | **Moral Check** | It acts as a moral check on the employees, from committing defalcations or embezzlement. |
| **(c)** | **Tax Liability** | Audited statements of account are helpful in settling liability for taxes |
| **(d)** | **Trade Dispute Settlements** | These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property by fire or some other calamity. |
| **(e)** | **Detection of wastages and losses** | An audit can also help in the detection of wastages and losses especially those that occur due to the absence or inadequacy of internal checks or internal control measures. |
| **(f)** | **Books of A/c** | Audit ascertains whether the necessary books of account have been properly kept and helps the client in making good deficiencies or inadequacies in this respect. |
| **(g)** | **Appraisal Function** | As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weaknesses, inadequacies etc., in them. |
| **(h)** | **Helpful at the time of Reconstitution of Firm** | Audited accounts are of great help in the statement of accounts at the time of admission or death of partner. |
| **(i)** | **Assistance to Government** | Government may require audited and certified statement before it gives assistance or issues a license for a particular trade. |
| **(j)** | **Credit Negotiation** | Financers and Bankers used Audited FS in evaluating the credit worthiness of Individuals in negotiating loans and It is also useful for determining the purchase consideration for a business. |

## *6. Objective of Audit*




As such there is only Objective that is Overall Objective but the Overall Objective can be divided into 2 parts i.e. –

1. **Expression of Opinion (Primary Objective)**
2. **Detection and Prevention Errors and Frauds. (Secondary Objective)**

1. **Expression of Opinion (EOP) –** As per SA – 200 (R), the Auditor to Express an Opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework

| S.N. | Points to Considered | Description |
|---|---|---|
| 1. | Objective of EOP | The objective of audit is to see that the statements of account convey true and not misleading (i.e. True and Fair) results and that errors and frauds do not exist as to distort what the accounts really should convey.<br>**Note** → The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. |
| 2. | Shifting of Opinion | The emphasis of audit has shifted from ***"true and correct" to "true and fair"***(The word "correct" was somewhat misplaced as the accounting largely consists of estimates; there has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements). |
| Did You Know This? | | It may also be clarified that the usage of words ***"true and fair"*** is restricted to certain countries such as U.K. while in other countries like United States the expression ***"full and fair"*** is prevalent. However both expressions aim to ***convey same meaning.*** |
| 3. | Proprietary concern | It is no part of auditor's duty to probe into the propriety of business conduct. |
| Did You Know This? | | In the leading case Re ***The London and General Bank Ltd. [1895]***. It was held that an auditor must ascertain that the books of account show the true financial position of the company. For the first time, the duties of the company auditor were spelled out in specific terms. Lord Justice Lindley observed, "It is ***no part of an auditor's*** duty to give advice either to ***directors or shareholders as to what they ought to do. (i.e. is not to go for proprietary)*** |
| 4. | Internal Control | It is the duty of the auditor to review the adequacy of internal procedures and separate the area of weak control. Taking note of the weakness found by him or makes suggestions to the management for minimizing the possibility of errors, frauds, taste, etc. He is concerned with evaluating the evidence in support of transactions. |
| 5. | Liability in case of planned fraud | The auditor must ***not be made liable*** for tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse suspicious and frauds are perpetrated (carried out a harmful action) by tried servants of the company and are undetected for years by the directors. |
| Did You Know This? | | The state of affairs came up for consideration in the ***Royal Mail Steam Packet Company's Case*** as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. |

2. **Errors and Fraud (Secondary Objective) – If the books of accounts are not properly maintained and the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them.**

| | | |
|---|---|---|
| 1. | As per SA – 240 | ☞ The ***primary responsibility*** for the prevention and detection of fraud rests with both ***those charged with governance of the entity and management.***<br>☞ An auditor conducting an audit in accordance with SAs is responsible for ***obtaining reasonable assurance*** that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.<br>☞ When obtaining reasonable assurance, the auditor is responsible for ***maintaining an attitude of professional skepticism throughout the audit,*** |

<table>
<tr><td></td><td></td><td>considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.</td></tr>
<tr><td colspan="2">Did You Know This?</td><td><u>Re S. P. Catterson & Sons Ltd.].</u><br>It is a matter of <u>safety for the business</u> because by acting on the <u>expert suggestions,</u> a better assurance for obtaining reliable accounts is there. It is a <u>safety for the auditor,</u> if in future he is hauled up before the Court to defend a charge of negligence for non-detection of errors and frauds; <u>it would be to his defence that he had already made the management aware of the weaknesses in the book-keeping system and procedures and the management had failed to act on his suggestions</u></td></tr>
<tr><td>2.</td><td>Check on Auditors performance regarding E&F</td><td>✓ Whether that the errors and frauds were such as could not be detected in ordinary course of checking without aid of special efforts.<br>✓ Whether the management has taken reasonable care to prevent errors and frauds.<br>✓ Whether the auditor had any reason to suspect the existence of the errors and frauds, and.<br>✓ Whether the errors or fraud was so be deep laid that the same might not have been detected by the application of normal audit procedures.</td></tr>
<tr><td colspan="2">Did You Know This?</td><td><u>[ Re-Kingston Cotton Mills Co.]</u><br>If there remains a <u>deep laid fraud</u> in the accounts, which in the normal course of examination of accounts may not come to light, it will <u>not be construed as failure of audit,</u> provided the auditor was not negligent in the carrying out his <u>normal work.</u></td></tr>
</table>

## 7. Causes and Nature/Classification/Forms of Errors and Fraud

The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

### 7.1 Classification of Errors

<table>
<tr><th>By R.K. Mautz (Nature)</th><th>Accounting Errors</th></tr>
<tr><td>1. Self – Revealing Errors and Non Self – Revealing Errors<br>2. Unintentional Errors and Intentional Errors<br>3. Unconcealed Errors and Concealed Errors<br>4. Errors affecting TB and Not affecting TB</td><td>1. Errors of Commission –<br>✓ Posting Errors<br>✓ Casting Errors<br>✓ Carry Forward Errors<br>✓ Duplication Errors<br>2. Errors of Omission –<br>✓ Partial Omission<br>✓ Total Omission<br>3. Errors of Principle –<br>✓ Effect which so not affect Profits<br>✓ Errors which affect Profits<br>4. Compensating Errors</td></tr>
</table>

### 7.2 Forms of Fraud

1. Manipulation, Falsification or Alteration of records or documents.
2. Misappropriation of Assets
3. Suppression or Omission of the effect of transactions
4. Recording of transactions without substance
5. Deliberate misapplication of accounting policies

### 7.3 Reasons and Circumstances of Errors and Frauds as under –

| S.N. | Errors | S.N. | Frauds |
|---|---|---|---|
| 1. | **Ignorance** on the part of employees of accounting developments, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general. | 1. | A **desire** to conceal the effect of defalcations of shortages of one kind or another. |
| 2. | **Carelessness** on the part of those doing the accounting work. | 2. | An ever present **desire** to hold taxes on income to minimum. |
| 3. | A **tendency** of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements. | 3. | **Intentional effort** committed by persons in position of authority to –<br>(a) Show up the picture depicted by the statements;<br>(b) Depress the picture depicted by the statements; and<br>(c) Convert the error to a personal benefit. |

## *8. Basic Principles Governing an Audit*

**While performing the audit the auditor has to comply with certain basic principles so that he will justify with noble profession of auditing.**

*SA 200(R)* states that these principles governing the auditor's professional responsibility inform of "***Requirements***" ***[Please refer SA – 200 (R) for details].***

***"They are briefly explained as under:"***

| Sr. | Basic Principles Governing | Details |
|---|---|---|
| 1. | **Integrity, Objectivity & Independence**<br>**Refer Code of Ethics – 2009** | 1. An auditor should be straight forward, honest and sincere in his approach.<br>2. He should maintain impartial (Fair) attitude towards his work i.e. he should audit with expertise skill of all the clients irrespective of the fees received from them.<br>3. He should avoid personal biases.<br>4. He should report without fear and favor.<br>5. Where his personal interest conflicts with organization's interest, he shall keep aside his personal interest. |
| 2. | **Confidentiality**<br>**Refer Code of Ethics – 2009** | 1. During the course of the audit the auditor gets certain information, details etc., which, if published, may prejudice the legitimate business interest of the client.<br>2. Therefore, he shall not disclose such confidential information to a third person unless consented by the client or is required by the auditor's legal or professional duty. |
| 3. | **Skills & Competence**<br>**Refer Code of Ethics – 2009** | 1. In the modern complex business world it becomes difficult for an auditor to check the record thoroughly.<br>2. He has to form certain opinion on his own judgment & skill.<br>3. Under such situation the auditor requires specialized skills and competence, which can be acquired through-a combination of general educational knowledge and practical experience under proper supervision.<br>4. He should be aware of the latest developments on the accounting and auditing matter pronounced by the ICAI and relevant regulations and statutory requirements. |

<table>
<tr><td>4.</td><td>Work performed by others<br>SA – 600 / 610 / 620</td><td>1. Looking at vastness of the business transactions, it is difficult for an auditor to do the work alone.<br>2. Therefore, the auditor delegates his work to assistants or use work performed by other auditors and experts e.g. internal auditors.<br>3. However, he will be responsible for forming and expressing his opinion on the financial statements, though he will be entitled to rely on work performed by others.<br>4. He is expected to exercise adequate skill and care and also obtain reasonable assurance that work performed by other persons is adequate for his purpose.</td></tr>
<tr><td>5.</td><td>Documentation<br>SA – 230</td><td>1. The auditor should document the matter which is important in providing evidence that the audit was carried out in accordance with the basic principles.<br>2. He may keep the audit notebook wherein the query is noted. He may also keep the working papers in files.<br>3. These files may be permanent working paper files and current working paper file.</td></tr>
<tr><td>6.</td><td>Planning<br>SA – 300</td><td>Before commencing the audit, the auditor should plan his work so that it may be conducted in an effective, efficient and timely manner.<br><u>Among other things, plans should cover</u> –<br>1. Acquiring knowledge of the client’s accounting systems, policies and internal control system.<br>2. Establishing the standard degree of reliance to be placed on internal control.<br>3. Planning the nature, timing and extent of the audit procedures.<br>4. Co-coordinating the work to be performed. A plan should be flexible so that they may be further developed and revised during the course of the audit.</td></tr>
<tr><td>7.</td><td>Audit Evidence<br>SA – 500 / 501</td><td>1. Before forming the opinion on the financial statements, the auditor should satisfy himself reasonably, by way of evidences obtained by him in the course of audit.<br>2. These evidences may be internal or external.<br>3. To draw the reasonable conclusions about the evidences he may use – compliance procedure and substantive procedures.
<table>
<tr><th>Compliance</th><th>Substantive</th></tr>
<tr><td>Are the test designed to obtain reasonable assurances of statutes, rules and regulations, authority, procedures, principles and internal control.</td><td>Are the test designed to obtain evidences as to the completeness, accuracy and validity of the data produced.<br><u>These test of 2 types:-</u><br>✌ Test of details of transactions and balances (i.e. Verification & Vouching).<br>✌ Analysis of significant ratios, trends and enquiry of unusual fluctuations of the items</td></tr>
</table></td></tr>
<tr><td>8.</td><td>Accounting and Internal Control System<br>SA – 315</td><td>1. It is the prime responsibility of the management to adopt the accounting system incorporating various internal controls which are appropriate to the size and nature of the business.<br>2. The auditor has to study these in detail and reasonably assure that they are adequate for forming his opinion.</td></tr>
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| | | |
|---|---|---|
| | | 3. Further, on the basis of effectiveness of the internal controls he can determine the nature, timing and extent of audit procedure. |
| 9. | Audit Conclusion & Reporting SA – 700 / 705 | **The auditor shall review and access the conclusion from the audit evidences obtained.**<br>***These conclusions may be*** **–**<br>1. The financial information is in accordance with acceptable accounting policies which have been constantly followed.<br>2. The information complies with the rules and regulations and statutory requirements.<br>3. There is adequate disclosure of all material facts relevant to the proper presentation of the financial information.<br>**Note** → After forming an opinion he has to report to the persons who have appointed him. The report should be clear. Any unqualified report shall be deemed to be full satisfaction of the auditor. Any qualification should be supported by proper reasons. |

**Note** → **In SA – 200 (R) Requirements not only includes above 9 points but also include Professional Judgement and Skepticism, comply with requirement SA's.**

## 9. Aspects to be covered in an Audit of FS

| S.N. | Aspects | Description |
|---|---|---|
| 1. | Internal Control System (ICS) | 1. An examination of the accounting and internal control systems to ascertain the appropriateness transactions for the business and whether it helps in properly recording all transaction.<br>2. It is followed by such tests and inquiries as are considered necessary to ascertain whether the system is in actual use. |
| 2. | System Review | Reviewing the systems and procedures to find whether they are adequate and comprehensive and incidentally whether material inadequacies and weakness exist. |
| 3. | Arithmetical Accuracy | Checking of arithmetical accuracy of the books of account. |
| 4. | Vouching | Verification of the authenticity and validity of transactions entered by and examination of books of account with the relevant supporting documents. |
| 5. | Accounting Principles | Ascertaining that a proper distinction is made between items of capital and revenue nature. |
| 6. | Books and Statements | Comparison of the balance sheet and profit and loss account with underlying record to see that they are in accordance therewith. |
| 7. | Assets | Verification of title, existence and value of assets and liabilities appearing in balance sheet. |
| 8. | Liabilities | Verification of Liabilities stated in the Balance Sheet. |
| 9. | True and Fair View | Checking of the results shown by the FS and see whether the results shown are T&F. |
| 9. | Statutory Compliance | Checking the result shown by the profit and loss account Confirming that the statutory requirements have been complied with, especially for audit of a corporate body. |
| 10. | Report | Reporting to the appropriate person /body whether the statements of account examined do reveal a true and fair view of the state of affairs. |

## 10. Scope of Audit:-

1. Again **SA 200 describes scope** / conduct of an auditing.
2. The scope of an audit of financial statements is based on the **terms of the engagement, requirements of relevant legislation and the pronouncements of the Institute.**

3. To form an opinion on the financial statements, the **auditor should be reasonably satisfied that source data is reliable and sufficient and is properly disclosed** subject to statutory requirements, where applicable.
4. His work involves an **exercise of judgment** and in **assessing the reasonableness of the judgments and estimates made by management** in preparing the financial statements.
5. The **audit cannot be relied upon to ensure the discovery of all frauds and errors** but where he has any indication that some fraud or error may have occurred resulting in material misstatement, he **should extend his procedures to confirm and dismiss his doubts.**
6. The auditor is **not expected to perform duties which fall outside the scope of his competence.**
7. Constraint on the scope of the audit of financial statements that **weaken the auditor's ability to express an unqualified opinion** should be set out in his report and a qualified and disclaimer of opinion should be expressed as appropriate.

## *11. Relationship of Auditing With Other Disciplines:-*

(a) Auditing is a unified function with its own philosophy, standards, techniques and, procedures.

(b) The field of auditing as a discipline in simple words involves review of its various assertions; both in financial as well as in non-financial terms, with a view to prove the reality of such declarations & expression of opinion by auditor on the same.

**Audit is logical and natural that the function of auditing is related to various other disciplines as:-**

| Discipline | Relationship |
|---|---|
| **Accounting** | ✓ Auditing process reviews the FS's, which are the result of the overall accounting process.<br>✓ The Auditor should have a thorough and sound knowledge of Accounting Standards and GAAP's for reviewing the FS's. |
| **Law** | Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into as required by Laws. |
| **Economics** | ✓ Accounting is concerned with the accumulation and presentation of data relating to economic activity.<br>✓ Auditing reviews the same from the micro – economics viewpoints.<br>✓ The auditor also takes into account, the general economic environment affecting the business, during the course of the work. |
| **Business Functions** | ✓ Auditor deals with the financial results of operational affair of the enterprise.<br>✓ The operational functions, i.e. Finance, Production, Cost Systems, Marketing, Personnel, Purchase, Logistics and other general areas of business management are inter – related and have an impact on the accounting process. |
| **Behavioural Sciences** | ✓ During the course of his work, the Auditor is required. To obtain information and explanations from the Client's staff.<br>✓ He has to interact with the organisation's staff in analysing the financial figures.<br>✓ The Auditor should have the knack of getting along with people, and other relevant information to meet his audit approach. |
| **Computer Sciences** | ✓ Clients carry out their financial accounting activities with the help of computers.<br>✓ To keep pace with technological developments, CAAT are adopted.<br>✓ EPD auditing is considered as a discipline in itself. |
| **Languages** | ✓ The knowledge of language is considered essential in auditing field, as the auditor is required.<br>✓ To communicate, both in writing as well as orally, in day – to – day work. |
| **Logic** | ✓ The auditing discipline itself is a logical construct.<br>✓ All audit processes and techniques focus on audit evidence evaluation and verifying assertions, which are bound by the rules of logic. |
| **Statistics** | ✓ Due to time, cost and other limitation, test check and sample check procedures are considered GAAP.<br>✓ Knowledge of probability and statistical theory will help in arriving at meaning audit conclusion. |

| | |
|---|---|
| **Mathematics** | ✓ As the auditor's deals with financial figures, mathematics plays an important role in audit work.<br>✓ Also, the auditor arrives at meaningful conclusions through analytical reviews or ratio analysis, for which the knowledge of mathematics is essential. |
| **Financial Mgt.** | ✓ The auditor should have a good knowledge of F.M. technique such as Working Capital Management, Funds Flow, Ratio Analysis, Capital Budgeting, etc.<br>✓ This will help in provide value added services to the Client rather than traditional ticking and reporting work. |
| **Production** | The auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for By – Products; Joint – Product may also require to be done. |

## *12. Inherent Limitations of an Audit:-*

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from –

(a) The **nature of financial reporting,**
**(b)** The **nature of audit procedures,**
**(c)** The need for the audit to be conducted within a **reasonable period of time and Balance between benefit and at a reasonable cost,**
**(d) Fraud involving senior Mgt. or collusion, and**
**(e) Occurrence of Non – Compliance with Laws and Regulations.**

## *13. Types of Audits:-*

| Particular | Statutory/Mandatory Audit | Voluntary/Independent Audit |
|---|---|---|
| **Meaning** | Audit is Prescribed by Law, i.e. Governing Statute or by the regulations governing the enterprise. | Audit is purely optional and at the discretion of the governing body. |
| **Examples of Enterprises** | Companies, Co – Operative Societies, Banking Regulation Act, 1949, Statute b which the Corporation is created e.g. IDBI Act, LIC, etc | Individuals, Private Trusts, Partnership Firms etc. which are not governed by act audit provisions of the Income Tax Act or Local Sales Tax Acts. |
| **Advantages** | Statutory Compliance is the main audit advantage. All advantages of audit accrue to the enterprise. | The advantages of Independent Audit are discussed earlier. |
| **Qualifications** | Only a person possessing the prescribed qualifications shall conduct the audit. | Qualifications for conducting audit are not prescribed by law. |
| **Scope** | It is defined by Law | It is defined by the Letter of Engagement between the Auditor and the Client. |
| **Auditors right/duties** | Where scope is defined by the Law, it cannot be restricted by the appointed authority. | It is defined by the Client and can be for partial audit also. |
| **Format of Report** | The matters to be covered in the Auditors Report are generally defined by Law. | The aspects to be covered by the Report are defined by the scope of work. |

## 14. Distinctions between Auditing and Accounting:-

| Particular | Accounting | Auditing |
|---|---|---|
| **Meaning** | Accounting is the art of recording, classing and summarizing financial information, transactions and events, and preparation of reports thereon. | An audit is Independent examination of financial information of any entity, when such an examination is conducted with a view to Expression an Opinion thereon. |
| **Objective** | Recording of Transactions from underlying vouchers and Preparation of Financial Statements | Verification of underlying vouchers and records and obtaining evidence on the True and Fair view presented by FS. |
| **Responsibilities** | It is the Mgt. primary responsibility to maintain and implement an effective accounting system. | Expression of opinion whether whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework |
| **Deals with** | Measurement and Communication of Information to Shareholders and other users of FS | Independent examination of Financial Information prepared by the Mgt of an entity. |
| **Aspect of Transaction** | Accounting involves recording aspects of Financial Information. | Auditing reviews the efficiency of recording Financial Information. |

## 14. Distinctions between Auditing and Investigation:-

| Particular | Investigation | Auditing |
|---|---|---|
| **Meaning** | Systematic, Critical and Special Examination of the records of a business for special purpose. | An audit is Independent examination of financial information of any entity, when such an examination is conducted with a view to Expression an Opinion thereon. |
| **Purpose** | To evaluate the state of affairs or to establish certain facts. | To report whether the FS present a T&F view of the Financial Position and Performance. |
| **Mandatory Nature** | Voluntary. | Mandatory for Companies. For other, it is voluntary. |
| **Appointing Agency** | Owners/Mgt/even Third Parties may appoint the Investigator. | Owners/Shareholders of the enterprise. |
| **Conducted by** | Any person, who need not necessarily be a CA | A CA within the meaning of the CA act, 1949. |
| **Scope** | Specific verification of certain areas laid down in the engagement letter. | Overall examination of Financial Information (General) |
| **Period Covered** | Not necessarily restricted to a Financial Year. | Generally a period of one Financial Year. |
| **Evidence** | Seeks conclusive and corroborative evidence. | Much of audit evidence is persuasive rather than conclusive. |
| **Financial Aspect** | Cover both Financial and Non Financial aspects. | Generally covers financial aspect only. |
| **Extent of Checking** | Detailed | Test checks may be applied, depending on the degree of reliance on internal control. |
| **Form of Reporting** | There is no Statutory form of Investigation report. | The matters to be covered in the audit report are sometimes prescribed by Law. |

## SA 200 (Revised)
## Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

| | | |
|---|---|---|
| 1. | **Effective Date** | April 1, 2010 |
| 2. | **Scope** | **To establish –**<br>(a) Overall objectives and general & overall responsibilities of the auditor.<br>(b) Nature and scope of the audit.<br>(c) Scope, authority & structure of the SAs<br>(d) Obligation to comply with the SAs |
| 3. | **An Audit of Financial Statements** | The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements by the expression of an opinion by the auditor that whether the financial statements are –<br>(a) Prepared in accordance with an applicable financial reporting framework;<br>(b) Presented fairly or give a true and fair view in accordance with the framework. |
| 4. | **Overall Objectives of the Auditor** | (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement.<br>(b) To report on the financial statements |
| 5 | **Requirements** | |
| | **Ethical Requirements** | Independence and Code of Ethics issued by ICAI needs to be followed. |
| | **Professional Skepticism** | Professional skepticism includes being alert to –<br>✓ Contradictory audit evidence ,<br>✓ Unreliable information, documents or inquiries.<br>✓ Conditions indicating fraud.<br>✓ Circumstances that suggest the need for audit procedures in addition to those required by the SAs. |
| | **Professional Judgement** | Professional judgment is necessary in particular regarding decisions about –<br>✓ Materiality and audit risk.<br>✓ The nature, timing, and extent of audit procedures required.<br>✓ Evaluation of audit evidence and management's judgements.<br>✓ The drawing of conclusions |
| | **Sufficient Appropriate Audit Evidence and Audit Risk** | The auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. |
| | **Conduct of an audit in accordance with SAs** | (a) Complying with SAs Relevant to the Audit;<br>(b) Objectives Stated in Individual SAs;<br>(c) Complying with Relevant Requirements;<br>(d) Failure to Achieve an Objective |

| SA-240<br>THE AUDITORS RESPONSIBILITIES RELATING FRAUD IN AN AUDIT OF FINANCIAL STATEMNETS | | |
|---|---|---|
| **1.** | **Effective Date** | 1-Apr-2009 |
| **2.** | **Scope** | Auditor's responsibility regarding fraud in an audit of financial statements. |
| **3.** | **Characteristics of Fraud** | Fraud is intentional & it causes material misstatement in the financial statements. |
| **4.** | **Responsibility for the prevention & detection of Fraud** | Such responsibility rests with management & those charged with governance of the entity. |
| **5.** | **Responsibilities of the auditor** | To obtain reasonable assurance that the Financial Statements are free from material misstatement, whether caused by Fraud or Error. |
| **6.** | **Objectives of the auditor** | (a) To identify & assess the risk of material misstatement due to fraud.<br>(b) To obtain appropriate audit evidence regarding aforesaid risk.<br>(c) To report the identified or suspected Fraud. |
| **7.** | **Requirements** | |
| | **Professional Skepticism** | Auditor should maintain an attitude of professional skepticism throughout the audit thereby detecting frauds & investigating inconsistencies. |
| | **Risk Assessment Procedures and related activities** | (a) Management & others within the entity (e.g. Internal Audit dept. & other employees) as well as those charged with governance should be enquired about whether they have knowledge of any actual, suspected or alleged Fraud.<br>(b) Auditor should obtain an understanding of :-<br>1. Management's procedures for identifying & responding to the risks of fraud & its assessment thereof.<br>2. Management's communication to those charged with governance in the matters of fraud.<br>3. How those charged with governance exercise oversight of management's processes for identifying and responding to the risks of Fraud & internal controls established by management to mitigate such risks. |
| | **Evaluation of fraud risk factors** | Information obtained from risk assessment procedures should be evaluated to identify presence of Fraud risk factors. |
| | **Identification and Assessment of the risk of material misstatement due to fraud.** | Auditor should assess such risks & obtain an understanding of entity's internal control relevant to them. |
| | **Responses to the assessed risks of material misstatement due to fraud.** | As per SA 330, overall responses should be determined to address such risks. |
| | **Audit procedures responsive to assessed risks of material misstatement due to fraud at the assertion level.** | Audit procedures whose nature, timing & extent is responsive to suck risks should be designed & performed. |

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|---|---|---|
| | **Audit procedures responsive to risks related to management override of controls.** | In order to mitigate such risks, auditor should design & perform audit procedures to review:-<br>(a) Journal entries and other adjustments in Financial Statements.<br>(b) Accounting estimates and biases.<br>(c) Significant transactions outside the normal course of the business. |
| | **Evaluation of Audit evidence indicative of fraud.** | In such a case implications of the misstatement should be evaluated in relation to other aspects of the audit. |
| | **Auditor unable to continue the engagement due to fraud** | In such a case, auditor should:-<br>(a) Consider his legal & professional responsibilities applicable in the circumstances.<br>(b) Consider appropriateness of his withdrawal from the engagement.<br>(c) Discuss & report his withdrawal with reasons thereof to the appropriate authority. |
| | **Management representations** | Auditor should obtain written representations from the management regarding:-<br>(a) Its responsibility regarding internal control in order to prevent & detect fraud.<br>(b) Disclosure to the auditor about the results of its assessment of risk of material misstatement due to fraud.<br>(c) Disclosure of its knowledge of fraud or suspected fraud or any allegations of fraud communicated by employees, former employees, analysts etc. |
| | **Communication to management and with those charged with governance** | Identified fraud should be communicated to the appropriate level of authority on a timely basis. |
| | **Communications to Regulatory & Enforcement Authorities** | Identified or suspected fraud should be communicated to such authorities if the auditor's legal responsibilities require him to do so. |
| | **Documentation** | (a) Significant decisions during the discussion in the matters of fraud.<br>(b) Identified and assessed risks of material misstatements due to fraud and its overall responses.<br>(c) Communications about fraud to the authority concerned.<br>(d) Any other presumptions & conclusions in the matter of fraud. |

## Some Questions

| | | |
|---|---|---|
| **Q. 1** | **State with reasons (in Short) whether the following statements are** | **True or False** |
| a. | Sampling is a major inherent limitation of audit. | |
| b. | There is no difference between terms "external audit" and "statutory audit". | |
| c. | Window Dressing is not a type of Fraud. | |
| d. | Audited Financial Statements doesn't help government. | |
| e. | Financial Statements are responsibility of management | |
| f. | A procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner. | |
| g. | "Auditor is not an insurer". | |
| h. | The auditor compares entries in the books of accounts with vouchers and if two agrees, his work is done. | |
| i. | The auditor, in the interest of users, while explaining the nature of his reservation, can describe the work of the expert with his name in the audit report without obtaining prior consent of the expert. | |
| j. | When an auditor indentifies a Misstatements resulting from fraud, it is his responsibility to communicate it to the regulatory and enforcement authorities apart from these charged with governance. | |
| **Q.2** | "An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs of the enterprise". Comment. | |
| **Q.3** | Distinguish between Auditing, Accounting and Investigation? | |
| **Q.4** | What do you understanding from Independent audit and give some advantages of independent Audit? | |
| **Q.5** | Discuss the types of audit required under law? | |
| **Q.6** | What are the basic aspects of audit to be covered by an auditor while conducting an audit of Financial Statement? | |
| **Q.7** | What are the auditor's responsibilities for detection of Frauds and Errors? | |
| **Q.8** | Discuss prerequisites and fundamental principles to be possessed by an auditor?<br>Or<br>What are the Basic Principles Governing in audit? | |
| **Q.9** | Write short note on General Purpose Financial Statements. | |
| **Q.10** | Write short notes on "factors governing modes of communication of auditor with those charge with governance. | |
| **Q.11** | Write Short note on "Error of Commission | |
| **Q.12** | "Doing a Statutory Audit is full of risk". Narrate the factors which cause the risk. | |
| **Q.13** | What is Inherent Limitation? Also give example. | |
| **Q.14** | State briefly the qualities of Auditors? | |
| **Q.15** | What do you understand by overall objective of Auditor? | |
| **Q.16** | How you will classify Audit? | |