

CHAPTER 1 - NATURE OF AUDITING

1. INTRODUCTION

The word 'auditing' has been derived from Latin word "audire" which means "to hear". Financial statements are often the basis for decision making, and decisions based on wrong accounting statements may prove very harmful to the business if Financial Statements are not properly examined. As a result, the **independent audit** of an entity's financial statements is a vital service to investors, trade payables, and other participants.

It may be noted that the management is responsible for establishing an accounting system to identify, measure, record and adequately disclose an entity's transactions and selecting accounting principles.

2. DEFINITION OF AUDITING

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.

The financial statements shall give a true and fair view of the state of affairs of the company or companies as at the end of the financial year. [CA2013-129]

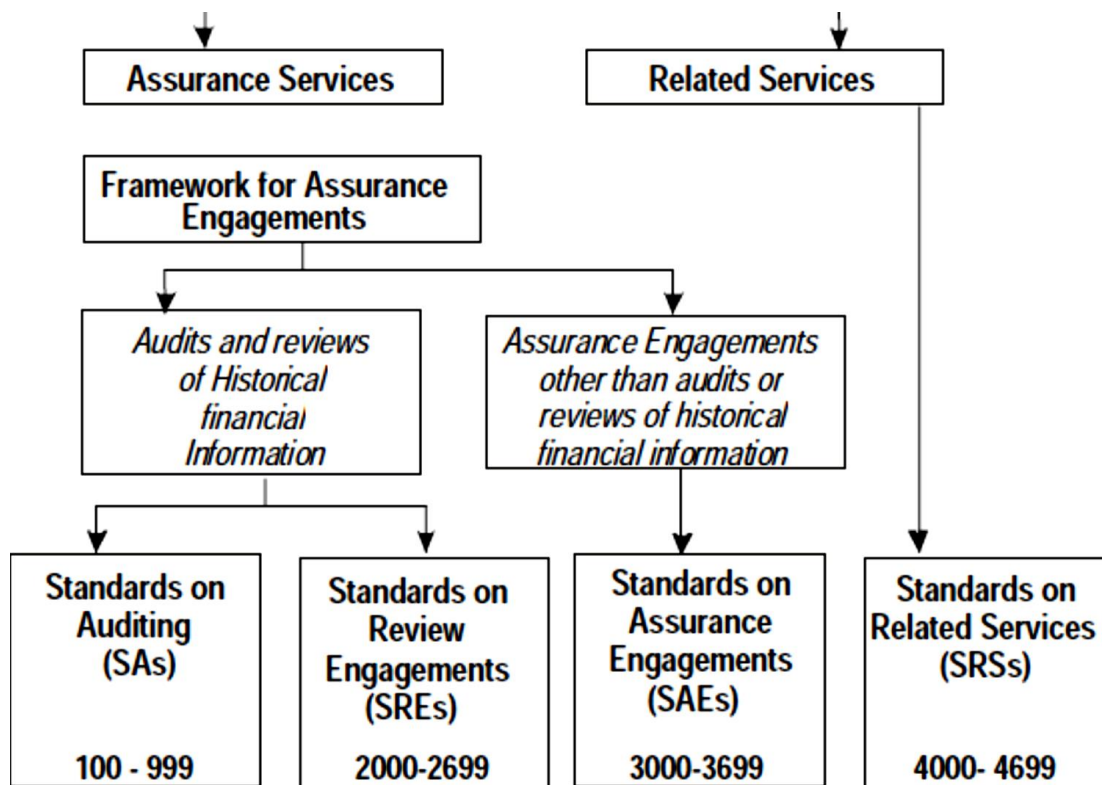
The auditor's report shall state that—

to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and the profit or loss and cash flow for the year and such other matters as may be prescribed [CA2013-143]

3. STANDARDS ON AUDITING

Auditing and Assurance Standards Board (AASB) issues various Standards on Quality Control, Auditing, Review, Other Assurance and Related Services which are as under:

1. **Standards on Auditing (SAs)**- to be applied in the audit of historical financial information
2. **Standards on Review Engagements (SREs)** - to be applied in the review of historical financial information
3. **Standards on Assurance Engagements (SAEs)** - to be applied in assurance engagements, engagements dealing with subject matters other than historical financial information
4. **Standards on Related Services (SRSS)** - to be applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.



Compliance with Documents Issued by the Institute:

The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters.

The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. **'Statements' therefore are mandatory.**

'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work. **Guidance Notes are recommendatory in nature.**

There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

4. THE AUDITOR

On the basis of functional division, auditors can be classified in two broad categories, namely, external auditors and internal auditors.

- ✓ External auditors are the persons who practice the profession of accountancy having qualified in the professional examination and are external to the organisation of which they audit. When an external auditor is appointed under a particular statute, such auditor may be known as the statutory auditor.
- ✓ The internal auditors, on the other hand, may be professionally qualified or not and are internal to the organization. As per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

5. OBJECTIVES OF AUDIT

Primary objective of audit is to express independent opinion. As defined in SA-200

“Auditing 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.**”

6. TYPES OF ERRORS

1. **Errors of omission** - where a transaction has been omitted either wholly or partially.
2. **Errors of commission** - where a transaction has been mis-recorded either wholly or partially. Error of commission can happen in the following ways:
 - a. Errors in posting,
 - b. Errors in Casting,
 - c. Errors in carrying forward,
 - d. Errors occurring during extraction of balances etc.
 - e. Posting errors may be of a wrong account, wrong amount or wrong file. For example, amount received from Mr X and credited to Mr Y.
3. **Compensating errors** - where there are two or more errors which exactly counter balance each other, so that the trial balance agrees in spite of them.
4. **Errors of principle** - these are errors arising as a result of transactions having been recorded in a fundamentally incorrect manner; for example, a distinction not being made between capital and revenue income or expenditure.

7. DETECTION OF FRAUD AND ERROR: DUTY OF AN AUDITOR

As per SA-240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.”

As per SA-240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, two types of intentional misstatements are relevant to the auditor’s consideration of fraud-misstatements:

- (i) **Fraudulent Financial Reporting:** It involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. For example, goods sold may not be recorded as sales but included in inventories
- (ii) **Misappropriation of Assets:** It involves the theft of an entity’s assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

SA-240, further explains by way of example lists certain risk factors and circumstances relating to possibility of fraud which may be considered by the auditor:

- ❖ High degree of competition or market saturation, accompanied by declining margins.
- ❖ Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- ❖ Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- ❖ Large amounts of cash on hand or processed.

Further SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,” explains that owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

Factors which may cause risk in conducting an audit are discussed below

- ❖ Exercising judgement on the part of the auditor:
- ❖ Nature of audit evidence: Much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom
- ❖ Inherent limitations of internal control

8. PRINCIPLES GOVERNING AN AUDIT

Presently there is no specific standard namely basic principles governing an audit but few general basic principles are as under:

1. Integrity, objectivity and independence
2. Confidentiality
3. Skills and competence
4. **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues to be responsible for forming and expressing his opinion on the financial information.
5. Documentation
6. Planning
7. **Audit Evidence:** should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures.
 - a. **Compliance procedures** are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.
 - b. **Substantive procedures** are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
8. **Accounting System and Internal Control:** Management is responsible for this but auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded.
9. Audit conclusions and reporting

9. SCOPE OF AUDIT

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the ICAI.

As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the **purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.**

The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control etc.

Aspects to Be Covered In Audit:

[State the matters which the statutory Auditor should look into before framing an opinion on accounts on finalisation of audit of accounts? Discuss over all audit approach.]

1. An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.
2. Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
3. Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
4. Ascertaining that a proper distinction has been made between items of capital and of revenue nature
5. Verification of the title, existence and value of the assets appearing in the balance sheet.
6. Verification of the liabilities stated in the balance sheet.

10. INHERENT LIMITATIONS OF AUDIT

The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from:

1. **The Nature of Financial Reporting:** Many financial statement items involve subjective decisions or assessments or a degree of uncertainty and some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.
2. **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence like management or others may not provide, intentionally or unintentionally, the complete information or Fraud may involve sophisticated and carefully organised schemes designed to conceal it etc.
3. **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** Auditors are expected to form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively.
4. **Other Matters that Affect the Limitations of an Audit :**
 - a. Fraud, particularly fraud involving senior management or collusion.
 - b. The existence and completeness of related party relationships and transactions.
 - c. The occurrence of non-compliance with laws and regulations.

11. AUDITING AND INVESTIGATION

Objective of Audit is to express an Independent opinion on financial statements, while **Investigation is a critical examination of the accounts** with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation.

Audit never undertakes discovery of specific happenings and is never started with a preconceived notion about the state of affairs. But, as per Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe

that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner prescribed.

As per Rule 13, such report shall be made not later than sixty days of his knowledge and after following the procedure indicated herein below:

1. auditor shall forward his report to the Board/Audit Committee, seeking their reply or observations within **forty-five days**;
 2. forward his report and the reply or observations of the Board or the Audit Committee along-with his comments to the Central Government within **fifteen days of receipt of such reply or observations**;
 3. in case the auditor fails to get any reply or observations within the stipulated period of forty-five days, he shall forward his report to the Central Government along-with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.
- ✓ The report shall be sent in ADT-4.
 - ✓ The provision of this rule shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor.
 - ✓ Punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees

12. TYPES OF AUDIT

Audits may be of two broad categories i.e., audit required under law and voluntary audits.

1. Audit required under law: The organisations which require audit under law are the following:
 - a. companies governed by the Companies Act, 2013;
 - b. banking companies governed by the Banking Regulation Act, 1949;
 - c. electricity supply companies governed by the Electricity Supply Act, 1948;
 - d. co-operative societies registered under the Co-operative Societies Act, 1912;
 - e. public and charitable trusts registered under various Religious and Endowment Acts;
 - f. corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.
 - g. Specified entities under various sections of the Income-tax Act, 1961.
2. In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc.

13. IMPORTANCE/ ADVANTAGES OF AN INDEPENDENT AUDIT

1. It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.
2. Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.
3. 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.
4. Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

5. Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

14. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

1. *Auditing and Accounting:*

- a. Both are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process.
- b. The auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.

2. *Auditing and Law:*

- a. The auditor should have a good knowledge of business laws affecting the entity.
- b. He should be familiar with the law of contracts, negotiable instruments, etc.
- c. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws.
- d. In analyzing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws

3. *Auditing and Economics:*

- a. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics.
- b. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations.
- c. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

4. *Auditing and Behavioral Science:*

- a. Financial auditor deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organization.
- b. The internal auditor or a management auditor is expected to deal with human beings rather than financial figures.
- c. One of the basic elements in designing the internal control system is personnel.

5. *Auditing and Statistics & Mathematics:*

- a. With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures.
- b. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.

6. *Auditing and Data Processing:*

- a. Organizations are witnessing revolution in the field of data processing of accounts.
- b. Many organizations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy.

7. Auditing and Financial Management:

- a. The auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.
- b. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place.
- c. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

8. Auditing and Production:

- a. 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-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor.
- b. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company.

Questions from PM

Q.1 Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.

- ❖ Weaknesses in the design of internal control system and non-compliance with the laid down control procedures
- ❖ Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees
- ❖ Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly
- ❖ Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.
- ❖ Problems in obtaining sufficient and appropriate audit evidence, e.g., significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

Q.2 Operational Audit

Operational Audit involves examination of all operations and activities of the entity.

The objects of operational audit include the examination of the control structure and of the relation of department controls to general policies.

It provides an appraisal of whether the department is operating in conformity with prescribed standards and whether efficiency and economy are maintained.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill.