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Nature, Objective and Scope of Audit

1.1 – Meaning and Nature of Auditing

<p>Meaning of Audit</p>	<p>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.</p> <p>This definition has the following implications:</p> <ul style="list-style-type: none"> (a) Audit is independent examination of financial information. (b) Requirement of audit applies in case of every entity, whether profit oriented or not (NGO or a Charitable Trust), whatever is business size of entity (Small Size entity or large size entity), whatever is the legal form of the entity (proprietor, partnership, LLP or company). (c) Purpose of audit is to express an opinion on the F.S. by means of written audit report. <div style="text-align: center;">Points to remember</div> <ul style="list-style-type: none"> • Independence implies that judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. • Auditor should be independent of entity whose F.S. are subject to audit so that he can form an opinion without being affected by any influence. • Independence increases auditor’s ability to act objectively. <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">Points to be ensured that F.S. not misled anybody</td> <td>Auditor engaged to perform task of performing audit need to ensure the following: <ul style="list-style-type: none"> (a) Accounts have been drawn up with reference to entries in books of account; (b) Entries in books of account are adequately supported by sufficient and appropriate evidence; (c) None of the entries in books of account has been omitted in the process of compilation; (d) Information contained in the F.S. is clear and unambiguous. (e) Amounts shown in F.S. are properly classified, described and disclosures are made in conformity with applicable ASs. (f) F.S. reflect true and fair view of financial results and financial position. </td> </tr> </table>	Points to be ensured that F.S. not misled anybody	Auditor engaged to perform task of performing audit need to ensure the following: <ul style="list-style-type: none"> (a) Accounts have been drawn up with reference to entries in books of account; (b) Entries in books of account are adequately supported by sufficient and appropriate evidence; (c) None of the entries in books of account has been omitted in the process of compilation; (d) Information contained in the F.S. is clear and unambiguous. (e) Amounts shown in F.S. are properly classified, described and disclosures are made in conformity with applicable ASs. (f) F.S. reflect true and fair view of financial results and financial position.
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<p>Inter-Disciplinary Nature of Auditing</p>	<p>Auditing is interdisciplinary in nature. It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects.</p> <ul style="list-style-type: none"> (a) Auditing and Accounting: Since audit of F.S. is concerned with financial information, a sound knowledge of accounting principles is a fundamental requirement for an auditor of F.S. to conduct audit and express an opinion. 		

	<p>(b) Auditing and Law: Good knowledge of business laws and various taxation laws helps auditor to understand F.S. in a better way in accordance with applicable laws.</p> <p>(c) Auditing and Behavioral Sciences: During course of audit, auditor has to interact with lot of persons for seeking information and making inquiries. This can be done only if one has knowledge of human behaviour.</p> <p>(d) Auditing and Statistics: Auditors use statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction.</p> <p>(e) Auditing and Economics: Knowledge of economics helps auditor to be familiar with overall economic environment in which specific business is operating.</p> <p>(f) Auditing and Financial Management: Financial management deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to have knowledge about these for applying some of audit procedures and carrying out audit effectively. Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.</p>		
<p>Objectives of Audit</p>	<p>As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing”, in conducting an audit of F.S., the overall objectives of the auditor are:</p> <p>(a) To obtain reasonable assurance about whether the F. S. 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 F.S. are prepared, in all material respects, in accordance with an applicable FRF, and</p> <p>(b) To report on the F.S. and communicate as required by the SAs, in accordance with the auditor’s findings.</p> <div style="background-color: #e0e0e0; padding: 5px; text-align: center;"> <p>Points to remember – Reasonable Assurance vs Absolute Assurance</p> <p>Absolute assurance is a complete assurance or a guarantee that F.S. 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.</p> </div>		
<p>Scope of Audit</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 20%; padding: 5px;">Elements included in Scope of Audit</td> <td style="padding: 5px;"> <p>(1) Coverage of all aspects of entity: Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.</p> <p>(2) Reliability and sufficiency of financial information: Auditor should be reasonably satisfied that information contained in accounting records and other source data (like bills, vouchers, documents etc.) is reliable and provide sufficient basis for preparation of F.S. For this purpose, auditor is required to study and assess accounting systems and internal controls.</p> <p>(3) Proper disclosure of financial information: Auditor should decide whether relevant information is properly disclosed in F.S in compliance with applicable statutory requirements. For this purpose, auditor is required to study and assess accounting systems and internal controls.</p> </td> </tr> </table>	Elements included in Scope of Audit	<p>(1) Coverage of all aspects of entity: Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.</p> <p>(2) Reliability and sufficiency of financial information: Auditor should be reasonably satisfied that information contained in accounting records and other source data (like bills, vouchers, documents etc.) is reliable and provide sufficient basis for preparation of F.S. For this purpose, auditor is required to study and assess accounting systems and internal controls.</p> <p>(3) Proper disclosure of financial information: Auditor should decide whether relevant information is properly disclosed in F.S in compliance with applicable statutory requirements. For this purpose, auditor is required to study and assess accounting systems and internal controls.</p>
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		<p>Ensuring that F.S. properly summarize transactions and events recorded therein and considering judgments made by management in preparation of F.S.</p> <p>Auditor should also evaluate whether accounting policies selected by management are proper and whether chosen policy has been applied consistently on a period-to-period basis.</p>
	Elements not included in Scope of Audit	<ul style="list-style-type: none"> • Auditor is not expected to perform duties which fall outside domain of his competence. • An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.
		Audit vs. Investigation
		<ul style="list-style-type: none"> • Audit is not an official investigation into alleged wrong doing. Auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation. • Investigation is a critical examination of 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. • Objective of audit is to obtain reasonable assurance about whether the F.S. as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion. • Scope of audit is general and broad whereas scope of investigation is specific and narrow.
Benefits of Audit		<p>(a) Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.</p> <p>(b) In case of companies, shareholders may or may not be involved in daily affairs of the company. F.S. are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.</p> <p>(c) Audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.</p> <p>(d) Audited F.S. are helpful to government authorities for determining tax liabilities.</p> <p>(e) Audited F.S. 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.</p> <p>(f) Audit may also detect fraud or error or both.</p> <p>(g) Audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.</p>

Mandatory Audit vs. Voluntary Audit	<ul style="list-style-type: none"> • Audit is not always legally mandatory. Entities like companies are compulsorily required to get their accounts audited under law. Non-corporate entities may be compulsorily requiring audit of their accounts under tax laws, if turnover crosses certain threshold limit. • Entities like schools may also be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government. • Many entities may get their accounts audited voluntarily because of benefits from the process of audit.
Who Appoints Auditor	<ul style="list-style-type: none"> • In case of companies, auditor is appointed by members (shareholders) in AGM. • In case of government companies, auditor is appointed by C&AG of India. • In case of a firm, auditor is appointed by partners of firm.
To whom Audit Report is submitted	<ul style="list-style-type: none"> • The report is submitted to person making the appointment. • In case of companies, these are shareholders; in case of a firm, to partners who have engaged him.

1.2 - Inherent Limitations of Audit

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the F.S. are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit which arises due to following factors:

(1) The Nature of Financial Reporting	<ul style="list-style-type: none"> • Preparation of F.S. involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors. • One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of F.S. in accordance with applicable FRF and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.
(2) Nature of Audit Procedures	<p>There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:</p> <p>(1) Auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.</p> <p>(2) Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as requested. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.</p>
(3) Not in Nature of Investigation	<p>Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors.</p>

(4) Timeliness of Financial Reporting & decrease in relevance of information over time	The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.
(5) Future Events	Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

1.3 – Meaning, Nature and Types of Engagements

Engagement	<ul style="list-style-type: none"> • An arrangement to do something. • In context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. • It takes the shape of engagement letter.
External audit engagements	Purpose of external audit engagements is to enhance the degree of confidence of intended users of F.S. Such engagements are also reasonable assurance engagements.
Assurance Engagement	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.
Elements of an Assurance Engagement	
<p>(a) Three Party relationship: An assurance engagement involves three parties – a practitioner, a responsible party, and intended users.</p> <ul style="list-style-type: none"> • Practitioner: Person who provides the assurance. Practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information. • Responsible party: Party responsible for preparation of subject matter. • Intended users: Persons for whom an assurance report is prepared. These persons may use the report in making decisions. <p>(b) Subject matter: Information to be examined by practitioner. For example: Financial information contained in F.S. while conducting audit of F.S.</p> <p>(c) Suitable Criteria: Benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.</p> <p>(d) Sufficient appropriate evidence: Practitioner performs an assurance engagement to obtain sufficient appropriate evidence. Conclusions are arrived and an opinion is formed on the basis of evidences. “Sufficiency” relates to quantity of evidence obtained; whereas “Appropriateness” relates to quality of evidence obtained.</p> <p>(e) Written assurance report: Outcome of an assurance engagement and contains conclusion that conveys the assurance about the subject matter.</p>	

Types of Assurance Engagements		Reasonable Assurance Engagement	Limited Assurance Engagement
	Level of Assurance	High, but not absolute	Lower than reasonable
	Nature of Procedures to obtain evidences	Elaborate and extensive procedures	limited procedures (Inquiry and Analytical Procedures)
	Conclusion Obtained	Reasonable conclusions.	Limited conclusions.
	Example	Audit engagement.	<ul style="list-style-type: none"> • Review engagement; • Examination of Prospective Financial Information (PFI); • Examine Internal Controls.
Examples of Assurance Engagements	<ul style="list-style-type: none"> • Audit of F.S. - Reasonable assurance engagement • Review of F.S. - Limited assurance engagement • Examination of PFI - Provides assurance regarding reasonability of assumptions forming basis of projections and related matters. • Report on controls operating at an organization - Provides assurance regarding design and operation of controls. 		
Audit Vs. Review	<ul style="list-style-type: none"> • Both “audit” and “review” are related to F.S. prepared on the basis of historical financial information. • Audit is a reasonable assurance engagement; review is a limited assurance engagement. • Review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up. 		
Prospective Financial Information (PFI)	<ul style="list-style-type: none"> • 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. • In assurance reports involving PFI, practitioner obtains sufficient appropriate evidence to the effect that <ul style="list-style-type: none"> (a) Management’s assumptions on which PFI is based are not unreasonable, (b) PFI is properly prepared on the basis of assumptions and (c) PFI is properly presented & all material assumptions are adequately disclosed. • As PFI is related to future events; evidences are available to support the assumptions on which the PFI is based, such evidences are also future- oriented. Practitioner is, therefore, not in a position to express an opinion as to whether the results shown in PFI will be achieved. 		

	<ul style="list-style-type: none"> • Therefore, practitioner provides a report assuring that nothing has come to his attention to suggest that these assumptions do not provide a reasonable basis for the projection. • Such type of assurance engagement provides only a “moderate” level of assurance.
	<p>“Historical Financial Information” & “Prospective Financial Information.”</p> <p>Historical Financial Information (HFI): Information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods.</p> <p>Prospective Financial Information (PFI): Financial information based on assumptions about occurrence of future events and possible actions by an entity.</p> <p>HFI is rooted in past events which have already occurred whereas PFI is related to future events.</p>

1.4 - Qualities of Auditor

Qualities	<ul style="list-style-type: none"> • Auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. • The qualities required are tact, caution, firmness, good temper, integrity, discretion, industry knowledge, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. • In addition, auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. • Auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review F.S. and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. • An exhaustive knowledge of accounting in all its branches is the <i>sine qua non</i> of the practice of auditing. He must know thoroughly all accounting principles and techniques.
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1.5 - Quality Control and Engagement Standards

Need for Standards	<ul style="list-style-type: none"> • Standards ensure carrying out of audit against established benchmarks at par with global practices. • Standards improve quality of financial reporting thereby helping users to make diligent decisions. • Standards promote uniformity as audit of F.S. is carried out following these Standards. • Standards equip professional accountants with professional knowledge and skill. • Standards ensure audit quality.
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Standards on Quality Control (SQC)	<ul style="list-style-type: none"> • Establish standards and provide guidance regarding a firm’s responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements. • SQC 1 has been issued and it requires auditors/practitioners to establish system of quality control so that: <ul style="list-style-type: none"> (a) firm and its personnel comply with professional standards and regulatory & legal requirements and (b) reports issued are appropriate. • SQC 1 applied for all services covered by Engagement Standards. 	
Engagement Standards	<p>“Engagement Standards” comprises the following Standards:</p> <p>(a) Standards on Auditing (SAs): to be applied in the audit of historical financial information.</p> <p>(b) Standards on Review Engagements (SREs): to be applied in the review of historical financial information.</p> <p>(c) Standards on Assurance Engagements (SAEs): to be applied in assurance engagements, engagements dealing with subject matter other than historical financial information.</p> <p>(d) Standards on Related Services (SRRs): to be applied to engagements involving application of agreed upon procedures to information and other related services such as compilation engagements.</p>	
Numbering of Standards	Standards on Quality Control (SQC)	01-99
	Standards on Auditing (SA)	100-899
	Standards on Review Engagements (SRE)	2000-2699
	Standards on Assurance Engagements (SAE)	3000-3699
	Standards on Related Services (SRS)	4000-4699
Classification of SAs	Introductory matters	100-199
	General Principles and Responsibilities	200-299
	Risk Assessments & Response to Assessed Risk	300-499
	Audit Evidence	500-599
	Using work of Others	600-699
	Audit conclusions and Reporting	700-799
	Specialised Areas	800-899
Standards on Auditing (SAs)	<ul style="list-style-type: none"> • SAs apply in the context of an audit of F.S. by an independent auditor. • These Standards establish high quality benchmarks and are followed by auditors in conducting audit of Historical Financial Information contained in F.S. • SAs have been issued on various issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on F.S. 	

	<ul style="list-style-type: none"> • Examples of SAs are: <ul style="list-style-type: none"> (a) SA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing. (b) SA 230: Audit Documentation. (c) SA 315: Identifying & Assessing Risks of Material Misstatement through Understanding the Entity and its Environment. (d) SA 500: Audit Evidence. (e) SA 700: Forming an Opinion and Reporting on Financial Statements
Standards on Review Engagements (SRE)	<ul style="list-style-type: none"> • SRE apply in the context of review of F.S. • Review is a limited assurance engagement and it provides assurance which is lower than that assurance provided by audit as review involves fewer procedures as compared to audit. • Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. • Examples of SREs are: <ul style="list-style-type: none"> (a) SRE 2400: Engagements to Review Historical Financial Statements. (b) SRE 2410: Review of Interim Financial Information Performed by Independent Auditor of the Entity <p>Note: Both SAs and SREs apply to engagements involving historical financial information.</p>
Standards on Assurance Engagements (SAE)	<ul style="list-style-type: none"> • SAEs deal with subject matters other than historical financial information. For example, an assurance engagement relating to examination of PFI. • In such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity. • Examples of SAEs are: <ul style="list-style-type: none"> (a) SAE 3400: The Examination of Prospective Financial Information. (b) SAE 3402: Assurance Reports on Controls at a Service Organisation. (c) SAE 3420: Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus.
Standards on Related Services (SRS)	<ul style="list-style-type: none"> • SRSs apply in case of Non-Assurance Engagements. Examples of such related services include engagements to perform agreed-upon procedures and Compilation Engagement. • Engagement to perform agreed-upon procedures require auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties etc. or a financial statement, say, a balance sheet or even a complete set of financial statements. • In Compilation engagement, practitioner is required to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. In such engagements, practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

