Chapter 1

NATURE, OBJECTIVE AND SCOPE OF AUDIT

1.1 MEANING OF AUDIT

Audit is an independent examination of Financial Information of an Entity which may be profit oriented or not; irrespective of its size and legal structure. The objective of such an examination is to express an opinion on the Financial Statements.

1.1.1 POINTS TO BE CONSIDERED WHILE CONDUCTING AN AUDIT

- The Person carrying out the Audit (Auditor) should at all times ensure that the Financial Statements and their Audit thereof should not mislead anybody;
- Auditor should be an independent person. In other words, one can say that he should not have any bias in his approach;
- He should not have any direct or indirect relationship or connection with the Client;
- The Financial Statements have been prepared by using acceptable accounting policies and adhering to prevalent regulations;
- The books of accounts maintained by the Client represents a true and fair view and is adequately backed up by sufficient and appropriate audit evidence;
- The information conveyed by the statements is clear and unequivocal.

1.2 OBJECTIVES OF AUDIT

As per SA 200 'Overall Objectives of the Independent Audit and the Conduct of an Audit in accordance with SAs' The purpose of an audit is to provide an objective independent examination of the financial statements, which increases the value and credibility of the financial statements produced by management, thus increase user confidence in the financial statement and reduce investor risk.

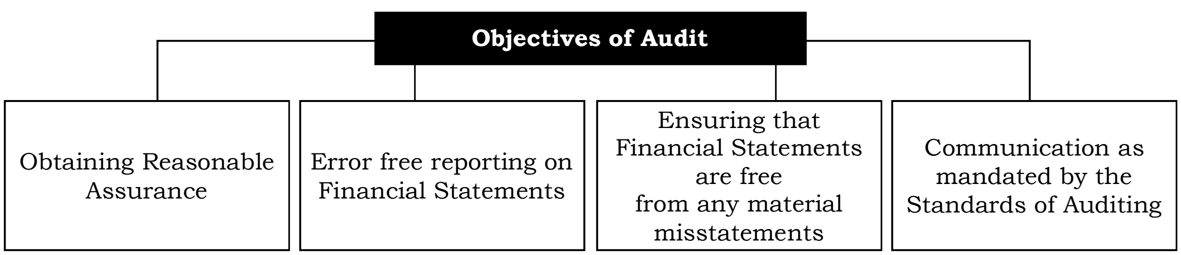

Figure 1.2(a): Objectives of Audit

1.3 SCOPE OF AUDIT

The scope of an audit is the determination of the range of the activities and the period of records that are to be subjected to an audit examination. The auditor can determine the scope of an audit of financial statements in accordance with the requirements of legislation, regulations or relevant professional bodies. It can be briefed as follows:

- The audit should be so organized so as to cover all aspects of the financial statements of an entity being audited;
- The auditor should obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for preparation of the financial statements;
- The Auditor while forming an opinion should decide whether the relevant information is properly communicated in the financial statements;
- The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by minutely studying and evaluating the accounting system and internal controls;

- Further, the auditor determines whether the relevant information is properly communicated and disclosed by comparing the financial statements with the underlying accounting records and other source data;
- The Auditor is also not expected to undertake responsibilities and perform functions which fall outside the scope of his competence.

1.3.1 PRINCIPAL ASPECTS COVERED IN AUDIT

- Examination of the structure of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by those tests and inquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account;
- Reviewing the system and procedures in order to find out whether they are adequate and complete so that no material inadequacies and weaknesses exist to allow frauds and errors going unnoticed;
- Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.;
- Verifying the validity of transaction by making an examination of the entries in the books of accounts with the relevant supporting documents;
- Ascertaining that a proper distinction has been made between items of capital and revenue nature and that the amounts of various items of income and expenditure are duly adjusted in the accounts corresponding to the relevant accounting period;
- Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith;
- Verification of the title, existence and value of the assets appearing in the balance sheet;
- Verification of the liabilities stated in the balance sheet;
- Scrutinizing the result shown by the profit and loss and to see whether the results shown are true and fair;
- Where audit is of a corporate body, confirming that the statutory requirements have been complied with;
- Reporting to the appropriate person/body whether the statements of account examined disclose a true and fair view of the state of affairs and of the profit and loss of the organization.

1.4 TYPES OF AUDIT

Audit is not a legal obligatory function or process to be followed strictly by all the entities. Accordingly, audits are classified into two categories as described in Figure 1.4(a) below.

A **Compulsory Audit**	All those entities obligated to mandatorily conduct an audit under any law. E.g. Companies governed under the Companies Act, 2013, Banking Companies and other Organizations governed and mandated to conduct Audit under respective Statutes
B **Voluntary Audit**	Even without specific obligation required by the law, many entities have the necessity, or think appropriate, to demand a qualified and independent professional judgment on their own financial reporting. Voluntary Audits include audit of the accounts of Proprietary Concerns, Partnership Firms, HUFs and so on. A voluntary audit is entirely for the benefit of the business and provides an independent assessment of the financial statements, management and controls.

Figure 1.4(a): Types of Audit

Note: *There are some special provisions in case of Audit of Non-Profit making Organizations. Most of these kinds of institutions generally have some internal rules and regulations governing their affairs. For efficient and effective management and control over the financial matters generally provision about the requirement of audit is inserted.*

1.5 ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

The aim of the audit is to verify that the financial statements have been made properly and meet the criteria set out under various Statutes. The auditing of financial statements provides so many benefits that it can be worthwhile even if the entity has no legal obligation to do so. There are numerous reasons for auditing financial statements which are as follows:

- Safeguarding the financial interest of the persons who are not directly associated with the management and administration of the entity;
- Audit activity acts as a moral check on the employees thereby preventing them from indulging in fraudulent activities like embezzlement, defalcations etc.;
- Helps in settling liability or claims for taxes and other statutory payments;
- Useful for settling trade disputes regarding claims related to wages, bonus or some other calamity;
- Helps in the detection of wastages and losses especially those occurring due to inadequacy of internal checks and control measures;
- Audit helps in ensuring that necessary books of account and auxiliary records have been properly kept and maintained;
- Audit function assists in reviewing the operations of various control measures;
- Audit functions are of great help at the time of settlement of accounts at the time of entry and exit of Partner(s);
- Various authorities most of the time require audited and certified statement before issuing licenses or permissions.

1.6 INHERENT LIMITATIONS OF AUDIT

Inherent limitations are such features of audit that constrains the auditor to obtain absolute assurance. It is because of these inherent limitations of audit the independent professional cannot assure the users of financial statements that financial statements are absolutely free of (material) misstatements. The Auditor is not expected to and even cannot practically reduce the audit risk to zero. Following are the reasons of the inherent limitations of Audit:

- While entering and reporting of many important financial quantities; management takes help of estimation which opens the door to inaccuracies;
- The preparation of financial statements involves judgement and decision of management regarding inclusion or exclusion of particular entry which leads to uncertainties and inaccuracies;
- At times there are also possibilities that the management, intentionally or unintentionally, may not provide the complete and relevant information to the Auditor which ultimately leads in faulty reporting;
- As an Auditor is not an official investigator, so is devoid of powers of search and investigation;
- Time and cost involved though is not a valid basis for an auditor to cut short the audit procedure but it is one of the prime inherent limitation;
- Relevance and adequacy of information is also an important criterion, which decides effectiveness of audit;

- The frauds are more difficult to detect because the frauds are normally well planned. The fraudulent person makes sure that fraud is not detected by the ordinary audit procedures. It becomes difficult for the auditor to detect these kind of instances;
- Non-compliance of laws (statutory and/or non-statutory) on the part of the entity is also a serious threat to efficient conduct of an audit.

1.7 INTERNATIONAL AUDITING AND ASSURANCE STANDARD BOARD

In the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. For achieving this purpose, the IFAC Board has established International Auditing and Assurance Standard Board (IAASB). ISSAB is an independent body which issued standards, like the International Standards on Auditing, Quality Control Guidelines and other services, to support the international auditing of financial statements. Following are the ways through which ISSAB achieves the stated objective:

- Establishing the high quality standards and guidance for financial audits that are in adherence to applicable laws and regulations;
- Establishing the high quality standards and guidance for other types of assurance services inclusive of financial and non-financial matters;
- Establishing the high quality standards and guidance for related services;
- Establishing the high quality standards for quality control;
- Publishing pronouncements on auditing and assurance matters.

SAs	Applied in the audit of historical financial information.
SREs	Applied in the review of historical financial information.
SAEs	Applied in assurance engagements, dealing with subject matters other than historical financial information.
SRSs	Applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.

Figure 1.7(a): Categorization of Auditing and Assurance

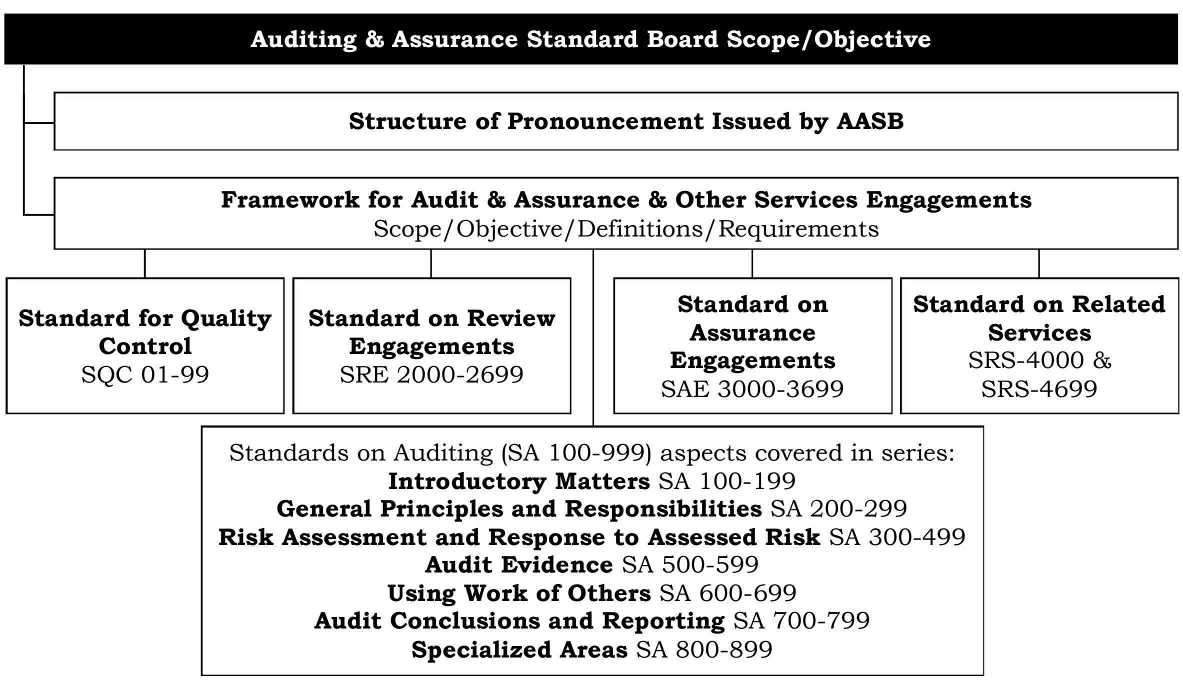

Figure 1.7(b): Structure of Standards

1.8 QUALITIES OF AN AUDITOR

An auditor is responsible for judging the validity and reliability of a company or organization's financial statements. An auditor is not bound to approach his work only with suspicion, or with the foregone conclusion that there is something wrong. So, an auditor is a professional that accumulates and evaluates evidence to report on the degree a company's assertions that they comply with an established set of procedures or standards. An efficient auditor must have certain qualities besides Professional qualification in order to carry out the audit efficiently and smoothly.

The qualities which an Auditor should have can be summed as follows:

- Having a well versed command over the basics and fundamental principles of all branches of accounting, finance, statutory as well as non-statutory laws etc. For example, General Accounting, Cost Accounts, Income-Tax, Companies Act, 2013 so and so forth
- Having a good knowledge and understanding of special kind of organizations with peculiar features
- Must have highest degree of integrity, discipline, firmness, judgement, patience backed up with a sufficient independence

1.9 ELEMENTS OF A SYSTEM OF QUALITY CONTROL

Leadership responsibilities for quality within the firm	**Ethical Requirements**	**Acceptance and continuance of client relationships and specific engagements**
Human Resources	**Engagement Performance**	**Monitoring**

Figure 1.9(a): Elements of a System of Quality Control

1.9.1 LEADERSHIP RESPONSIBILITIES FOR QUALITY ON AUDITS

The actions of the engagement partner(s) and engagement team are responsible for the overall quality of an audit by emphasizing on the following points:

- Performing work that complies with Professional standards and legal requirements;
- Complying with the firm's quality control policies;
- Issuing Auditor's Report that is appropriate and correct;
- The engagement team's ability to raise concerns whenever required without the fear of reprisals.

1.9.2 ETHICAL REQUIREMENTS DURING THE CONDUCT OF AN AUDIT

Following are the fundamental principles of Professional Ethics relevant to the conduct of an effective Audit:

- Integrity
- Professional Competence
- Professional Behavior
- Confidentiality
- Objectivity

The Auditor while conducting Audit should be independent in relation to the entity. The term independent here is used in relation to

"Independence as to Mind and Independence as to Appearance"

Independence as to Mind means the state of mind that permits the performance of audit and attestation without being affected by influences that compromise the professional judgement, objectivity and professional skepticism.

Independence as to Appearance means the avoidance of those facts and circumstances that can potentially make the third party believe and question the Auditor's integrity, objectivity and professional skepticism.

Note: *Independence of the Auditor has not only to exist in fact, but also appear to exist to all reasonable persons. Independence in appearance is what third parties would perceive as being independence so you are perceived by others to be independent.*

Though there could possibly be multiple situations, combinations and circumstances that could potentially affect the independence of an Auditor and it is impossible to define every situation precisely that may create a threat to independence yet for the sake of knowledge and understanding, below is a list of situations, which are a threat to the independence of an Auditor.

- **Self-review Threats:** Self-review threat is a threat when the auditor, auditing firm, partner or associate has prepared some of the accounting for the fund. E.g. auditor recently been serving as a director or senior partner in the same Company etc.
- **Self-interest Threats:** This threat emerges when, for example, an auditor has only one client or one client represents a significant proportion of their business. For example, potential employment with client, undue dependence on client's fees, direct or indirect material interest etc.
- **Advocacy Threats:** Advocacy threat occurs when the auditor is being asked to promote or represent their client in some way. For example, when an auditor is involved in dealing and trading of shares or securities of the Company.
- **Relationships Threats/Familiarity Threats:** Relationship threats are broad and generally cover anything that involves the auditor knowing the SMSF trustees, members, or accountant on a personal level. For example, having a close family or business relationship with a trustee, audit team, client counterparts.
- **Intimidation Threats:** This threat occurs when auditors are prevented from acting objectively thereby inducing them to report differently to gain undue advantage. For example, threat of replacement, pressure to disproportionately reduce work in response to reduced audit fees.

1.9.2.1 SAFEGUARDS TO INDEPENDENCE

The accounting service to the audit client is provided in accordance with the audit firm's policies and procedures. The following are the guiding principles in this regard:

- Ensuring that the accounting service is not performed by a member of the audit team;
- Policies and procedures to ensure members of the audit team do not make or assume responsibility for management decisions for the audit client;
- Discussing independence issues with the board of directors or audit committee;
- Requiring source data for the accounting entries to be provided by the client;
- Lastly, if the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

1.9.2.2 PROFESSIONAL SKEPTICISM

Professional skepticism is the state of mind which is ready for the situation that grabs out the errors or questions the financial events and other events while conducting an audit or assurance engagement. Professional skepticism is actually an attitude of the questioning mind. The Auditor shall plan and perform an audit with an attitude of skepticism so as to be able to recognize the circumstances which can cause the financial statements to be materially misstated.

For example, Professional skepticism includes following:

- Audit evidence that are contradictory with other audit evidence obtained;
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence;
- Circumstances indicating possible frauds;
- Circumstances suggesting need for additional audit procedures apart from Auditing Standards;
- Maintaining Professional Skepticism trough out the conduct of an Audit.

Professional Skepticism is the critical assessment of the audit evidences. Like the professional judgment, professional skepticism is required when conducting the assurance engagement. An auditor should have the skeptic mind which will make him alert for the situations to avoid material misstatement. He should be cautious of the chances of errors. In cases of doubt about the reliability of information or indication of possible fraud, the SAs require that the auditor should investigate further and recommend/suggest possible modifications/corrections.

1.9.3 CLIENT RELATIONSHIPS AND AUDIT ENGAGEMENTS

Audit firms are encouraged to approach client acceptance and continuance with selectivity, taking on and retaining only those audit clients that are consistent with their ethical obligations. Due diligence on prospective clients is a necessary step for reducing risk, and an audit firm that fails to take a selective approach to client acceptance may face financial losses, reputational damage and even litigation.

Client acceptance and continuance procedures should focus on independence considerations, possible conflicts of interest and whether the firm is competent to perform the engagement, and has the capabilities, including time and resources to do so.

1.9.4 HUMAN RESOURCES

The firm should establish policies and procedures which are designed to provide reasonable assurance regarding sufficiency of personnel with the capabilities, competence and commitment to ethical principles. Following is the list addressing personnel issues:

- Recruitment
- Eligibility and Capability
- Promotion
- Competence
- Compensation
- Personnel Needs

1.9.5 ENGAGEMENT PERFORMANCE

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards, regulatory and legal requirements. Through its policies and procedures, whether through written or the firm seeks to establish consistency in the quality engagement performance. Matters which are addressed under this include following:

- The way in which engagement team is briefed in order to obtain a clear understanding of the objectives of their work;
- Process for complying with applicable engagement;

- Supervision, coaching and training of engagement team and staff;
- Reviewing the work performed;
- Appropriate documentation;
- Keeping a track of current policies and procedures.

1.9.6 MONITORING

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and complied with in practice. Following is the list of monitoring compliance with quality control policies and procedures in order to evaluate:

- Compliance with professional standards and legal requirements;
- Ensuring that quality control system has been appropriately designed and effectively implemented;
- Ensuring, keeping in mind the current conditions and circumstances, that the firm's quality control policies and procedures have been appropriately applied.

1.10 PRECONDITIONS FOR AN AUDIT

Once the audit engagement is finalized, SA 210 "Agreeing the Terms of Audit Engagements" comes into picture. SA 210 defines preconditions for an audit as follows, "The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.". For determining the pre-conditions for an audit, the auditor shall ensure the following:

- Confirming whether the financial reporting framework is acceptable;
- Confirmation from the management regarding the acknowledgement and understanding of responsibilities for:
  - Preparation of the financial statements
  - Internal Control Mechanism;
- Providing the auditor with necessary data, records, documentation, additional information for the purpose of conduct of an Audit;
- Providing auditor an access to persons from whom the necessary audit evidences could be procured.

1.11 AUDIT ENGAGEMENT TERMS

As there are various types of entities governed by separate legal and statutory requirements, hence it is therefore imperative for both auditor and client to acquaint themselves about the nature of engagement. The engagement terms should be reduced in writing and should exactly specify the scope of work.

Note: *In case of Partnerships, more caution is required as the appointment of an auditor in case of Partnerships is governed by Partnership Deed.*

The Audit engagement shall be in an approved written form and shall include:

- Objective and scope of the Audit Engagement
- Responsibilities of the Auditor
- Responsibilities of the Management
- Applicable Financial Reporting Framework
- Valid reference to the expected form and content of report to be issued by an Auditor

1.12 RECURRING AUDITS

In recurring audits, the auditor assesses the circumstances requiring the revision in the terms of audit engagement and/or reminding the existing terms of the audit engagement. Following are the factors leading to the necessity of recurring audit:

- Indication that entity misunderstands the objective and scope of Audit
- Revision or existence of any special term
- Change in top level/senior management
- Significant change in ownership structure
- Changes in legal/statutory or regulatory framework
- Change in financial reporting framework
- Change in any other reporting requirement

1.13 LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If Management or Those Changed With Governance (TCWG) imposes a limitation on the scope of the auditor's work in such a manner that it results into disclaimer of opinion by an Auditor, then the Auditor shall not accept such a limited engagement until and unless required by law.

1.14 ACCEPTANCE OF A CHANGE IN ENGAGEMENT

There may be circumstances demanding a change in the terms of the audit engagement and that is done after a detailed discussion and giving a proper thought both by the auditor and the client. If found necessary, audit engagement is then accordingly changed and accepted by the Auditor.

A request for the change of the engagement may result because of the following reasons:

- Change in circumstances
- Misunderstanding
- Restriction on the scope of the engagement

Note: *A change in the Audit Engagement is considered only when there is a justifiable ground for doing so.*

If an Auditor is not willing and ready to accept the changed terms of the Audit Engagement, then he shall:

- Either withdraw from the Audit Engagement
- Or report the circumstances to the other parties or authorities/regulators