1. NATURE, OBJECTIVE AND SCOPE OF AUDIT

1. 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."

2. OBJECTIVES OF AUDIT

☞ As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

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

3. SCOPE OF AUDIT

☞ The following points merit consideration in regard to scope of audit:

i) The audit should be organized to cover adequately all aspects of the enterprise relevant to the financial statements being audited.

ii) To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records is reliable and sufficient.

iii) In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed.

iv) The auditor assesses the reliability and sufficiency of the information by:

a) making a study and evaluation of accounting systems and internal controls **AND**

b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate.

v) The auditor determines whether the relevant information is properly disclosed in the financial statements by:

a) **comparing the financial statements with the underlying accounting records and other source data** to see whether they properly summarize the transactions and events recorded; and

b) **considering the judgments that management has made in preparing the financial statements** accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

vi) The auditor is not expected to perform duties which fall outside the scope of his competence. For example, determining physical condition of certain assets.

vii) Constraints on the scope of the audit that impair auditor's ability to express an unqualified opinion should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

3.1 ASPECTS TO BE COVERED IN AUDIT

i) 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.

ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and whether material inadequacies and weaknesses exist to allow frauds and errors.

iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.

iv) Verification of the authenticity and validity of transaction entered by making an examination of entries in the books of accounts with relevant supporting documents.

v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature.

vi) Comparison of balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance.

vii) Verification of the title, existence and value of assets appearing in balance sheet.

viii) Verification of the liabilities stated in the balance sheet.

ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.

x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

xi) Reporting to the appropriate person/body whether the statements of account examined reveal a true and fair view.

4. TYPES OF AUDIT

☞ Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories:

i) Audit required under law; **AND**

ii) Voluntary audits.

i) AUDIT REQUIRED UNDER LAW

☞ The organisations which require audit under law are the following:

- Companies governed by the Companies Act;
- Banking companies;
- Other statutory bodies required by their regulators or by specific Act.

ii) VOLUNTARY AUDITS:

☞ These are the audits of the accounts of proprietary entities, partnership firms, HUFs, etc. In such cases, there is no basic legal requirement of audit. But their internal rules require audit.

☞ They may be required to get their accounts audited on the directions of Government for various purposes like sanction of grants, loans, etc.

☞ But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited.

5. ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

☞ The advantages are given below:

i) **It safeguards the financial interest of persons who are not associated** with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.

ii) **It acts as a moral check on the employees** from committing defalcations or embezzlement

iii) Audited statements of account are **helpful in settling liability for taxes,** negotiating loans and for determining the purchase consideration for a business.

iv) 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.

v) 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.

vi) **Audit ascertains whether the necessary books of account and allied records have been properly kept** and helps the client in making good deficiencies or inadequacies in this respect.

vii) As an appraisal function, **audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.

viii) Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner.**

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

6. INHERENT LIMITATIONS OF AUDIT

☞ As per SA 200 auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

☞ The inherent limitations of an audit arise from:

i) The Nature of Financial Reporting

☞ The preparation of financial statements involves judgment by management. It also involves subjective decisions or assessments or a degree of uncertainty.

ii) The Nature of Audit Procedures

☞ There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is possibility that management may not provide, intentionally or unintentionally, complete information that is relevant or that has been requested by the auditor.
- Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures may be ineffective for detecting an intentional misstatement that involves collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

iii) Timeliness of Financial Reporting and Balance between Benefit and Cost:

☞ The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure. Appropriate planning assists in making sufficient time and resources available for conduct of audit.

☞ Notwithstanding this, the relevance of information and its value, tends to diminish over time and there is a balance to be struck between the reliability of information and its cost.

iv) Other Matters that Affect the Limitations of an Audit:

☞ In case of certain subject matters, limitations on auditor's ability to detect material misstatements are particularly significant. These matters include:

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.

d) Future events or conditions that may cause an entity to cease to continue as a going concern.

7. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

The function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

i) Auditing and Accounting

- ☞ Auditing reviews the financial statements which are nothing but a result of the overall accounting process. Auditor should have a thorough and sound knowledge of generally accepted principles of accounting

ii) Auditing and Law

- ☞ An auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc.
- ☞ The knowledge of taxation laws (direct as well as indirect) is also expected as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws.

iii) Auditing and Economics

- ☞ Auditor is expected to be familiar with the overall economic environment of the client. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics.
- ☞ 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.

iv) Auditing and Behavioural Science

- ☞ Knowledge of human behaviour is essential for an auditor to effectively discharge his duties. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures.

v) Auditing and Statistics & Mathematics

- ☞ Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories. The use of data analytics is advancing rapidly in auditing where many organizations are using continuous auditing and continuous monitoring of data to identify risks as part of their system of internal control.

vi) Auditing and Data Processing

- ☞ Many organisations 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.

vii) Auditing and Financial Management

☞ Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. 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.

viii) Auditing and Production:

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

☞ 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- products may also require to be done.

8. STANDARD SETTING PROCESS

Auditing and Assurance Standards Board: ICAI is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. ICAI constituted the AASB (erstwhile Auditing Practices Committee) to review the existing auditing practices in India and to develop Engagement and Quality Control Standards (erstwhile Statements on Standard Auditing Practices) so that these may be issued by the Council of the Institute.

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards: In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz

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

9. QUALITIES OF AN AUDITOR

- He 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, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all qualities that go to make a good businessman contribute to making of a good auditor.
- He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.
- He must have a thorough knowledge of the general principles of the Companies Act, mercantile law, law relating to contracts.
- He must pursue an intensive programme of theoretical and education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary.
- The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit.
- The 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 financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. He must know thoroughly all accounting principles and techniques.
- Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had briefly 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".

10. ELEMENTS OF A SYSTEM OF QUALITY CONTROL (SA 220)

☞ The firm's system of quality control should include policies and procedures addressing each of the following elements:

a) Leadership responsibilities for quality within the firm.

b) Ethical requirements.

c) Acceptance and continuance of client relationships and specific engagements.

d) Human resources.

e) Engagement performance.

f) Monitoring.

10.1 Leadership Responsibilities for Quality on Audits

☞ As per SA 220, engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

☞ The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

a) The importance to audit quality of:

i) Performing work that complies with professional standards and regulatory and legal requirements;

ii) Complying with the firm's quality control policies and procedures as applicable;

iii) Issuing auditor's reports that are appropriate in the circumstances; and

iv) The engagement team's ability to raise concerns without fear of reprisals; and

b) The fact that quality is essential in performing audit engagements.

10.2 Ethical Requirements Relating to an Audit of Financial Statements

☞ The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.

☞ The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

a) Integrity;

b) Objectivity;

c) Professional competence and due care;

d) Confidentiality; and

e) Professional behaviour.

☞ The auditor should be independent of the entity subject to the audit. The Code describes independence as comprising both:

- Independence of Mind and
- Independence in Appearance.

I. Independence of Auditors

☞ Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

☞ It is not possible to define "independence" precisely. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

☞ There are two interlinked perspectives of independence of auditors:

a) **Independence of mind** – state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

b) **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

II. Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

i) **Self-interest threats:**

☞ These occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

☞ Examples include:

- Direct financial interest or materially significant indirect financial interest in a client,

- Loan or guarantee to or from the client,
- Undue dependence on a client's fees and, hence, concerns about losing the engagement,
- Close business relationship with an audit client,
- Potential employment with the client, and
- Contingent fees for the audit engagement.

ii) Self-review threats

☞ These occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement or when a member of audit team was previously a director or senior employee of client. Instances where such threats come into play are

- when an auditor having recently been a director or senior officer of the company, and
- when auditors perform services that are themselves subject matters of audit.

☞ Non audit engagement include any professional services provided to an entity by an auditor, other than audit or review of financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.

iii) Advocacy threats

☞ These occur when the auditor promotes a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third-party disputes.

iv) Familiarity threats

☞ They are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways:

- Close relative of the audit team working in a senior position in the client company,
- Former partner of the audit firm being a director or senior employee of the client,

- Long association between specific auditors and their specific client counterparts, and
- Acceptance of significant gifts or hospitality from the client company, its directors or employees.

v) Intimidation threats

☞ These occur when auditors are prevented from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to reduce work in response to reduced audit fees.

III. Safeguards to Independence

☞ The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. The following are the guiding principles in this regard: -

i) For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

ii) In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

iii) Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

iv) When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.

v) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

IV. Professional Skepticism

☞ **Professional skepticism** refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

☞ Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

☞ Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

10.3 Acceptance and Continuance of Client Relationships and Audit Engagements

☞ SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical
- requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

10.4 Human Resources

☞ Such policies and procedures address the following personnel issues such as Recruitment, Performance evaluation, Capabilities, Competence, Career development, Promotion, Compensation; and Estimation of personnel needs.

☞ Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements.

10.5 Engagement Performance

☞ Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

10.6 Monitoring

☞ The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and regulatory and legal requirements;
- Whether the quality control system has been appropriately designed and effectively implemented; and
- Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

☞ Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

11. AGREEING THE TERMS OF AUDIT ENGAGEMENT (SA 210)

☞ In order to establish whether the PRE CONDITIONS FOR AN AUDIT are present, the auditor shall:

a) Determine whether the financial reporting framework is acceptable; and

b) Obtain the agreement of management that it acknowledges and understands its responsibility:

i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

ii) For the internal control as management considers necessary; and

iii) To provide the auditor with:

- Access to all information such as records, documentation and other matters;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

12. ELEMENTS OF A SYSTEM OF QUALITY CONTROL

☞ According to SA 210 "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- The objective and scope of the audit;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

☞ If law or regulation prescribes in detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies.

13. RECURRING AUDITS

☞ The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

14. LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

☞ If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

15. ACCEPTANCE OF A CHANGE IN ENGAGEMENT

☞ An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

☞ A request from the client for the auditor to change the engagement may result from-

a) a **change in circumstances** affecting the need for the service,

b) **a misunderstanding** as to the nature of an audit or related service originally requested.

c) **a restriction on the scope of the engagement,** whether imposed by management or caused by circumstances.

☞ The **auditor would consider carefully the reason given for the request,** particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

☞ If the auditor concludes that there **is reasonable justification to change the engagement** and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement.

☞ The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

☞ If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

☞ If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

a) Withdraw from the audit engagement where possible under applicable law or regulation; and

b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.