



Chapter 1 - Nature, Objective & Scope of Audit

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Why do
we need
Audit?





Who are the
Users of
Financial
Statements?



Management
& Employees

Government
& Govt
Agencies

Customers

Financial
Statements

Investors &
Analysts

Competitors

Lenders

Meaning of Audit

Audit 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 if the FS is a True & Fair.

Case Study

Tirav Lokhi is a CEO of Honest Business Pvt Ltd . His brother, Hitesh Sharma is a practicing Chartered Accountant. He engages Hitesh Sharma to do the audit of his company. Hitesh accepts and completes the audit and issues a clean certificate.

Is the action of the CA correct?

No. There would be no independence in such a case due to relationship by birth between CA and his brother. He would be subject to influence from his brother



Independence



What is Independence

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

The auditor should be independent of entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence.

Case Study

A CA has invested in the shares of a company. He is approached by the Company to do the audit of the same. Can he accept the Audit?

No. As he is holding the shares of the company his own self-interest gets involved. His own money is invested in the company and he may not be able to form judgment independently on the financial statements of the company

Case Study

A CA is engaged to do the audit of the concern. It's a small proprietary concern and the owner requests him to prepare the books of accounts also. The CA agrees. Is this action okay?

No. The auditor cannot prepare the books of accounts and also do the audit. It will be a conflict of interest and the audit will not be independent.

Who Prepares & Maintains Books of Accounts?



Management of the Company



Is Audit Needed only for a Profit Making or Profit Oriented Company?

No - Both Loss Making and non Profit Oriented Companies also need audit

The entity need not necessarily be a for profit organization. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a small, medium or large.

Further, it can be conducted for any entity irrespective of its legal structure i.e. such an entity may be a proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.

OBJECTIVE OF THE AUDIT

Auditing provides assurance.

Its basic nature lies in providing assurance to users - providing confidence to users of financial statements.

Such an assurance lends credibility to financial statements.

Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

CASE STUDY

Mr. Bukayo Saka is appointed as the auditor of Coach India Private Limited. He completes the audit and issues in a clean audit report without any issues. Subsequently a fraud by the Directors is unearthed after years of investigation. The stakeholders of Coach India Private Limited want to take action against Mr. Bukayo Saka stating that he has not properly done the audit and he has not given the user of the financial statement absolute assurance as he should have done.

Justify if the action is correct?

No – As per SA 200 – Audit only gives reasonable assurance. Audit is not an investigation into alleged wrong doings

SA - 200 - Overall Objectives of the Independent auditor and the conduct of an audit

- a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error and in accordance with an applicable financial reporting framework
- b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings



“Auditor is a watchdog,
not a bloodhound.”

~ Justice Lopes in case of Kingston Cotton Mill

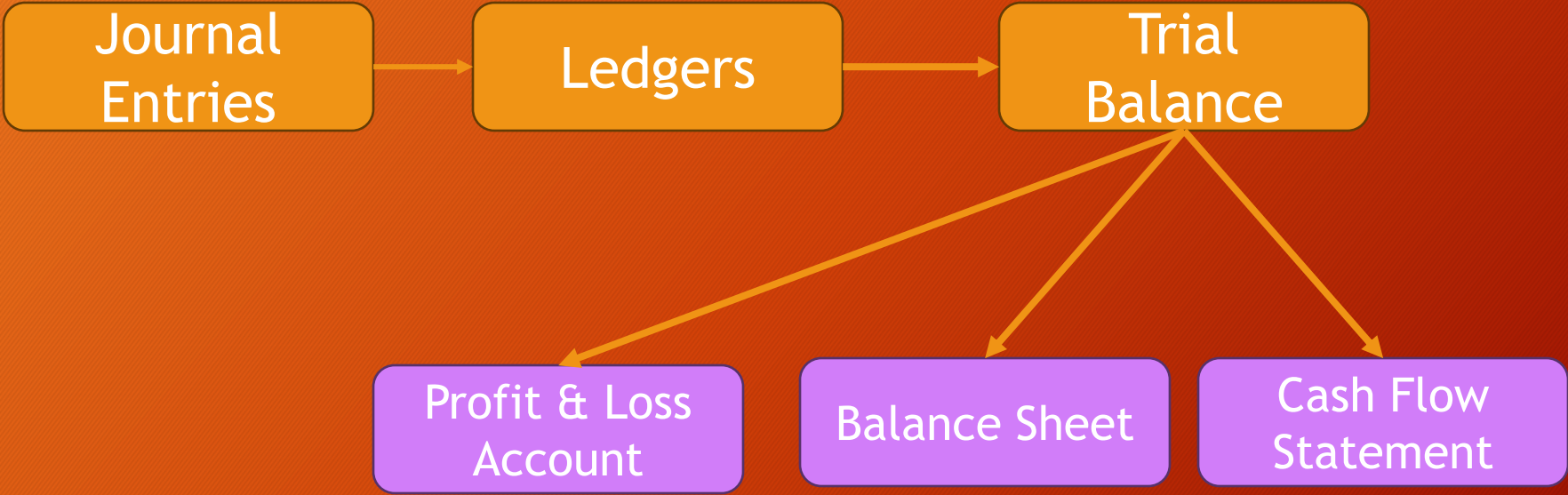
Reasonable Assurance

- Audit is distinct from investigation. Investigation is a critical examination of the 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.
- The objective of audit, on the other hand as we have already discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
- Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong-doing; about some wrong having been committed. The auditor seeks to report what he finds in normal course of examination of accounts.



What Does the Audit Cover





Journal Entries

COVERAGE OF AUDIT

- the accounts have been drawn up with reference to entries in the books
- the entries in the books are adequately supported by sufficient and appropriate evidence
- none of the entries has been omitted in the process of compilation;
- the information conveyed by the statements is clear and unambiguous;
- the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

SPECIFIC ASPECTS COVERED IN AUDIT

Vouching of
Transactions

Verification of
Assets & Liabilities

Examination of
Accounting
System and
Internal Controls

Review of Systems
and Procedures

Statutory
Compliance

Expression of
Opinion

Who Appoints the Auditor?

- In case of a Company - the shareholders - appointed at AGM
- Government Companies - Appointed by CAG
- In case of a Firm - By the Partners
- In case of Proprietorship - By the sole proprietor

Audit Report is also submitted to the person who appointed the auditor

EXAM QUESTION

MGPK is proprietorship firm engaged in the manufacturing of textile products. It sells its finished products both in India & abroad. The total turnover is Rs. 50 crores. It has also availed cash credit limit of Rs. 5 crores from Banks. The proprietor is worried about the financial position and since he is based out of India, worried the firm might run into losses. He approaches CA Lakshmi about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise accordingly.

Advantages of Getting Audited

- Audit ascertains whether the necessary books of account and allied records have been properly kept
- Helps Statutory Compliance
- It safeguards the financial interest of persons who are not Associated
- It acts as a moral check on the employees
- Audited statements of account are helpful in settling taxes & negotiating loans and for determining the purchase consideration for a business
- useful for settling trade disputes



LIMITATIONS OF AUDIT

INHERENT LIMITATIONS OF AUDIT – THEORY QUESTION

- **Nature of Financial Reporting** - preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.
- **Nature of Audit Procedures** - There are practical and legal limitations on the auditor's ability to obtain audit evidence. Management or others may not provide intentionally or unintentionally. Fraud can be sophisticated and carefully organized to conceal it. Further, an auditor does not have legal powers like an investigator
- **Timelines 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 for which there is no alternative. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.
- **Other Matters that Affect limitations of Audit** – Fraud, related party transactions, non-compliance with other laws, future events that may cause the going concern risk



Questions



Case Study

M/s KYC & Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s KYC & Co.:

- (a) Preparation of financial statements
- (b) Designing, implementation and maintenance of internal control system
- (c) Reporting on true and fair view of financial statements
- (d) Compliance with the applicable law and regulation

(C) - Reporting on True & Fair View

Case Study

Which of the following is the responsibility of the auditor:

- (a) Preparation and presentation of the financial statements in accordance with applicable financial reporting
- (b) Design, implementation and maintenance of internal controls
- (c) Express an opinion on the Financial Statements
- (d) To obtain limited assurance

(C) - Express an opinion on the FS

Case Study

The matter of difficulty, time, or cost involved is :

(a) not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

(b) in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

(c) not in itself a valid basis for the auditor to omit an audit procedure for which alternative exists.

(d) not in itself a valid basis for the auditor to omit an audit procedure

(A)

Case Study

The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :

- (a) management
- (b) Those charged with governance
- (c) audit committee
- (d) Auditors

(B)

Case Study

The Auditor of a Sole Proprietor Concern is appointed by

- (a) CAG
- (b) Bank
- (c) Sole Proprietor himself
- (d) District Administration

(C)

Case Study

With respect to auditing, which of the following statement is correct:

- (a) Audited financial statements are absolutely free from all material misstatement due to fraud or error.
- (b) An audit is an official investigation into alleged wrongdoing and auditor has specific legal powers to conduct investigation
- (c) The auditor can obtain only a reasonable assurance about whether the financial statement as a whole are free from material misstatement and report on it.
- (d) An auditor's opinion is an assurance as the future viability of the enterprise or the efficiency or effectiveness of the management

(C)

Case Study

Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of

- (a) Independence
- (b) Professional Judgement
- (c) Professional skepticism
- (d) All of the above

(B)

Question

Examine with reasons (in short) whether the following statement is correct or incorrect:

The preparation of financial statements involves judgment by management.

TRUE - The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made

Question

State with reason (in short) whether the following statements are true or false:

The auditor's opinion helps determination of the true and correct view of the financial position and operating results of an enterprise.

Incorrect: The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise.

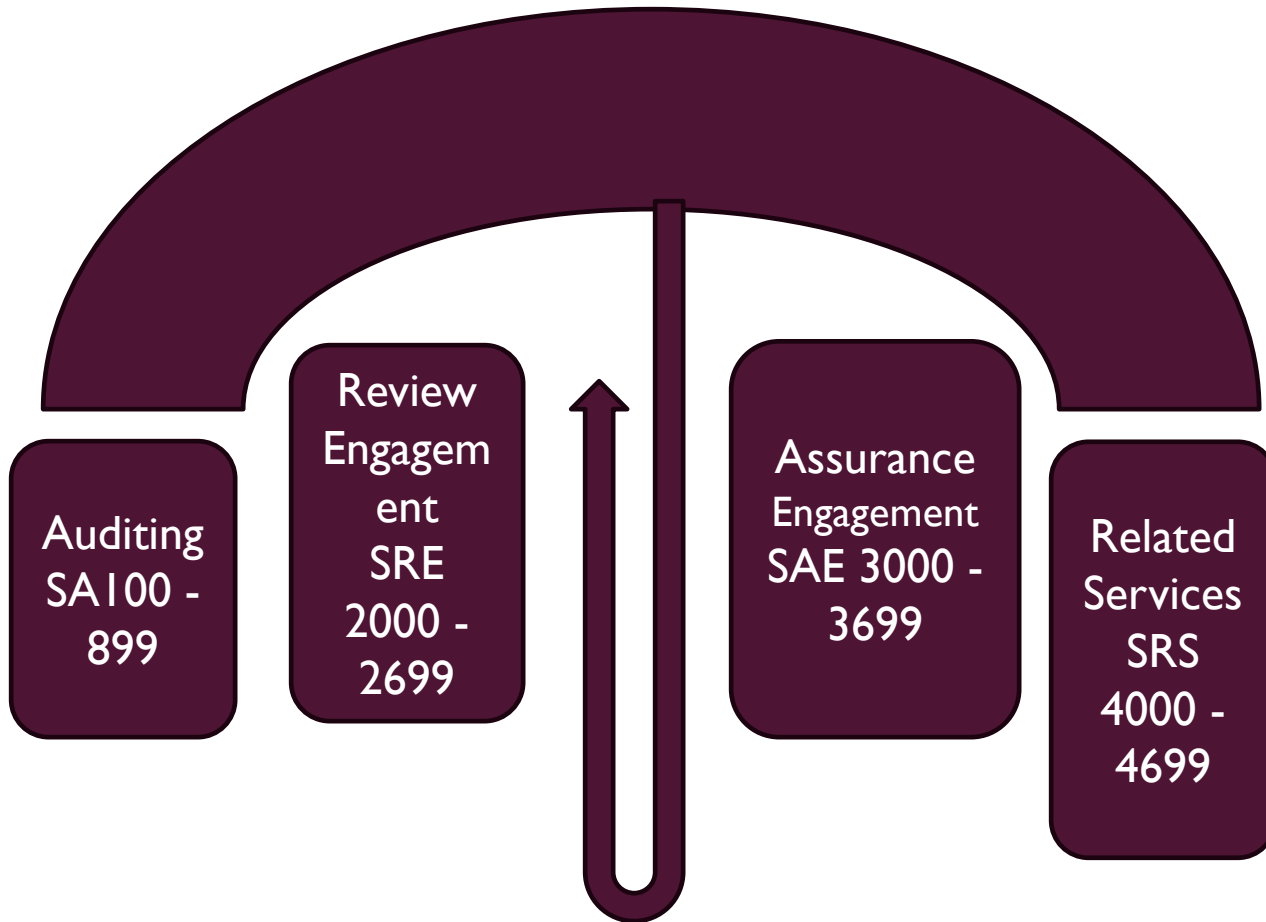
Is Audit Compulsory?

- Not Always legally mandatory
- Companies are mandated to get audited under Companies Act
- Non Companies may need to get audited under some other act, like the Income Tax Act requires compulsory audit beyond a specified threshold
- LLP Act has a limit of Rs.40 Lakhs turnover for audit of LLPs
- Trust/NPOs/NGOs may need to get audited for getting grants
- Other people may prefer voluntary audit because of benefits

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THANK YOU!



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STILL HAVE ANY DOUBTS?

LETS DISCUSS!

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