

Lecture 2

Nature, Objective and Scope of Audit

(1)	Meaning and Nature of Auditing
	Meaning of Audit
	<i>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.</i>
	<ul style="list-style-type: none"> • Independence implies that judgement of a person is not subordinate to wishes or direction of another person who might have engaged him. • Independence increases auditor's ability to act objectively.
	Points to be ensured that F.S. not misled anybody
	(a) Accounts have been drawn up with reference to entries in books of account;
	(b) Entries in books of a/s are adequately supported by sufficient & appropriate evidence;
	(c) None of the entries in books of account has been omitted in process of compilation;
	(d) Information contained in F.S. is clear and unambiguous.
	(e) Amounts shown in F.S. are properly classified, described & disclosures are made in conformity with applicable ASs.
	(f) F.S. reflect true and fair view of financial results and financial position.
	Inter-Disciplinary Nature of Auditing
	Auditing is interdisciplinary in nature.
	(a) Auditing and Accounting: Since audit of F.S. is concerned with financial information, sound knowledge of accounting principles is a fundamental requirement for an auditor.
	(b) Auditing and Law: Good knowledge of business & various taxation laws helps auditor to understand F.S. in a better way in accordance with applicable laws.
	(c) Auditing and Behavioral Sciences: During course of audit, auditor has to interact with lot of persons for seeking information & making inquiries. This can be done only if one has knowledge of human behaviour.
	(d) Auditing and Statistics: Auditors use statistical methods to draw samples in scientific manner. It is not possible for an auditor to check each and every transaction.

(e) Auditing and Economics: Knowledge of economics helps auditor to be familiar with overall economic environment in which specific business is operating.
(f) Auditing and Financial Management: Financial mngt. deals with issues like funds flow, working capital mngt., ratio analysis etc. and auditor is expected to have knowledge about these for applying some of audit procedures and carrying out audit effectively.
Objectives of Audit
As per SA 200 "Overall Objectives of Independent Auditor & Conduct of Audit in accordance with SAs", in conducting an audit of F.S., overall objectives of auditor are:
(a) To obtain reasonable assurance about whether F. S. as a whole are free from material misstatement, whether due to fraud or error, thereby enabling auditor to express an opinion on whether F.S. are prepared, in all material respects, in accordance with applicable FRF, and
(b) To report on F.S. & communicate as required by SAs , in accordance with findings.
Reasonable Assurance vs Absolute Assurance
<i>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.</i>
Scope of Audit
(a) Elements included in Scope of Audit
(1) Coverage of all aspects of entity: Audit of F.S. should be organized adequately to cover all aspects of entity relevant to the F.S.
(2) Reliability & sufficiency of financial information: Auditor should be reasonably satisfied that information contained in a/cing records & other source data (like bills, vouchers, documents etc.) is reliable & provide sufficient basis for preparation of F.S. For this purpose, auditor is required to study and assess and accounting systems internal controls.
(3) Proper disclosure of financial information: To decide whether information is properly disclosed in F.S in compliance with applicable statutory requirements, auditor is required to study and assess accounting systems and internal controls. Evaluate whether accounting policies selected by mngt. are proper & whether chosen policy has been applied consistently on a period-to-period basis.

	(b) Elements not included in Scope of Audit
	<ul style="list-style-type: none"> Auditor is not expected to perform duties which fall outside his competence. Auditor is not expert in authentication of documents. 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 critical examination of accounts with a special purpose. For example, if fraud is suspected & it is specifically called upon to check accounts whether fraud really exists, it takes character of investigation. Objective of audit is to obtain reasonable assurance about whether F.S. as a whole are free from material misstatement, whether due to fraud or error, thereby enabling auditor to express an opinion. Scope of audit is general & broad; scope of investigation is specific and narrow.
	Benefits of Audit
	(a) Audited accounts provide high quality information & gives confidence to users that information on which they are relying is qualitative and it is outcome of exercise carried out by following Auditing Standards recognized globally.
	(b) In case of companies, shareholders may or may not be involved in daily affairs of company. F.S. are prepared by mngt. consisting of directors. As shareholders are owners, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit .
	(c) Audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
	(d) Audited F.S. are helpful to government authorities for determining tax liabilities .
	(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.
	(f) Audit may also detect fraud or error or both.
	(g) Audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

	Mandatory Audit vs. Voluntary Audit
	❖ <i>Audit is not always legally mandatory. Entities like companies are compulsorily required to get accounts audited under law. Non-corporates may be compulsorily requiring audit of accounts under tax laws, if turnover crosses certain threshold limit.</i>
	❖ <i>Entities like schools may be required to get accounts audited for purpose of obtaining grant or assistance from the Government.</i>
	❖ <i>Many entities may get their accounts audited voluntarily because of benefits from the process of audit.</i>
	Who Appoints Auditor
	❖ <i>In case of companies, auditor is appointed by members (shareholders) in AGM.</i>
	❖ <i>In case of government companies, auditor is appointed by C&AG of India.</i>
	❖ <i>In case of firm, auditor is appointed by partners of firm.</i>
	To whom Audit Report is submitted
	❖ <i>Report is submitted to person making the appointment.</i>
	❖ <i>In case of companies, these are shareholders; in case of a firm, to partners who have engaged him.</i>
	(2) Inherent Limitations of Audit
	<i>As per SA 200 "Overall Objectives of Independent Auditor and Conduct of an Audit in accordance with SAs" auditor is not expected to, & cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that F.S. are free from material misstatement due to fraud or error.</i>
	<i>This is because there are inherent limitations of an audit which arises due to following factors:</i>
	(1) Nature of Financial Reporting
	❖ <i>Preparation of F.S. involves making many judgments by mngt. These judgments may involve subjective decisions or uncertainty. Therefore, auditor may not be able to obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors.</i>

- ❖ One of premises for conducting an audit is that mngt. acknowledges its responsibility of preparation of F.S. in accordance with applicable FRF and for devising suitable ICs. However, such controls may not have operated to produce reliable financial information due to their own limitations.

(2) Nature of Audit Procedures

There are practical & legal limitations on auditor's ability to obtain audit evidence.

For example:

- (1) Auditor does not test all transactions & balances. He forms his opinion only by testing samples. It is an **example of practical limitation** on auditor's ability to obtain audit evidence.
- (2) Mngt. may not provide complete information as requested by auditor. There is no way by which auditor can force mngt. to provide complete information. 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.

(3) Not in Nature of Investigation

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.

(4) Timeliness of Financial Reporting & decrease in relevance of information over time

Relevance of information decreases over time & 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. 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.

DO PRACTICE – Questions from Cracker (Question Bank)