

## Lecture 3

# Nature, Objective and Scope of Audit

(3)	<b>Meaning, Nature and Types of Engagements</b>
	<b>Engagement</b>
	<ul style="list-style-type: none"> <li>• An arrangement to do something.</li> <li>• In context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services.</li> <li>• It takes the shape of engagement letter.</li> </ul>
	<b>External audit engagements</b>
	Purpose of external audit engagements is to enhance the degree of confidence of intended users of F.S. Such engagements are also <b>reasonable assurance engagements</b> .
	<b>Assurance Engagement</b>
	Engagement in which a practitioner expresses a conclusion designed to enhance degree of confidence of intended users other than responsible party about outcome of evaluation or measurement of a subject matter against criteria.
	<b>Elements of an Assurance Engagement</b>
	(a) <b>Three Party relationship:</b> Assurance engagement involves 3 parties: <ul style="list-style-type: none"> <li>• <b>Practitioner:</b> Person who provides assurance. Practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.</li> <li>• <b>Responsible party:</b> Party responsible for preparation of subject matter.</li> <li>• <b>Intended users:</b> Persons for whom an assurance report is prepared. These persons may use report in making decisions.</li> </ul>
	(b) <b>Subject matter:</b> Information to be examined by practitioner. For example: Financial information contained in F.S. while conducting audit of F.S.
	(c) <b>Suitable Criteria:</b> Benchmarks used to evaluate subject matter like standards, guidance, laws, rules and regulations.
	(d) <b>Sufficient appropriate evidence:</b> Practitioner performs assurance engagement to obtain sufficient appropriate evidence. Conclusions are arrived & opinion is formed on basis of evidences.

“Sufficiency” relates to **quantity of evidence**; whereas “Appropriateness” relates to **quality of evidence**.

(e) **Written assurance report**: Outcome of assurance engagement & contains conclusion that conveys the assurance about the subject matter.

### Types of Assurance Engagements

	<b>Reasonable Assurance Engagement</b>	<b>Limited Assurance Engagement</b>
<b>Level of Assurance</b>	High, but not absolute	Lower than reasonable
<b>Nature of Procedures to obtain evidences</b>	Elaborate & extensive procedures	limited procedures (Inquiry & APs)
<b>Conclusion Obtained</b>	Reasonable conclusions.	Limited conclusions.
<b>Example</b>	Audit engagement.	<ul style="list-style-type: none"> <li>• Review engagement;</li> <li>• Examination of PFI.</li> </ul>

### Examples of Assurance Engagements

- **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

- Both “audit” & “review” are related to F.S. prepared on basis of historical financial information.
- Audit is a **reasonable assurance** engagement; review is **limited assurance** engagement.
- Review involves **fewer procedures** and gathers sufficient appropriate evidence on basis of which **limited conclusions** can be drawn up.

### Prospective Financial Information (PFI)

- Financial information based on assumptions about events that may occur in future & possible actions by an entity.

- It can be in form of a forecast or projection or combination of both.
- In assurance reports involving PFI, practitioner obtains sufficient appropriate evidence to effect that:
  - (a) Management's assumptions on which PFI is based are not unreasonable,
  - (b) PFI is properly prepared on 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 assumptions on which PFI is based, such evidences are also future- oriented. Practitioner is, therefore, not in a position to express an opinion as to whether results shown in PFI will be achieved.
- Therefore, practitioner provides 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.

#### **"Historical Financial Information" & "Prospective Financial Information."**

**Historical Financial Information (HFI):** Information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods.

**Prospective Financial Information (PFI):** Financial information based on assumptions about occurrence of future events and possible actions by an entity.

HFI is rooted in past events which have already occurred whereas PFI is related to future events.

#### **(4) Qualities of Auditor**

- ❖ Auditor is concerned with **reporting on financial matters** of business & other institutions. Financial matters inherently are to be set with problems of human fallibility; errors and frauds are frequent.
- ❖ Qualities required are **tact, caution, firmness, good temper, integrity, discretion, industry knowledge, judgement, patience, clear headedness and reliability.**
- ❖ In addition, auditor must have highest degree of **integrity backed by independence.**
- ❖ Auditor must have **basic human qualities** apart from technical requirement.
- ❖ **Exhaustive knowledge of accounting** in all its branches is sine qua non of practice of auditing. He must know thoroughly all accounting principles and techniques.

<b>(5)</b>	<b>Quality Control and Engagement Standards</b>
	<b>Need for Standards</b>
	❖ Standards ensure carrying out of <b>audit against established benchmarks</b> at par with global practices.
	❖ Standards <b>improve quality of financial reporting</b> thereby helping users to make diligent decisions.
	❖ Standards <b>promote uniformity</b> as audit of F.S. is carried out following these Standards.
	❖ Standards <b>equip professional accountants with professional knowledge and skill</b> .
	❖ Standards <b>ensure audit quality</b> .
	<b>Standards on Quality Control (SQCs)</b>
	❖ Establish standards & provide guidance regarding <b>firm's responsibilities for its system of QC</b> for conduct of audit & review of historical financial information and for other assurance and related service engagements.
	❖ <b>SQC 1</b> has been issued and it requires auditors/practitioners to establish system of QC so that:
	(a) firm and its personnel <b>comply with professional standards</b> and regulatory & legal Requirements; and
	(b) <b>reports issued are appropriate</b> .
	❖ <b>SQC 1 applied for all services</b> covered by Engagement Standards.
	<b>Engagement Standards</b>
	(a) <b>Standards on Auditing (SAs)</b> : to be applied in audit of historical financial information.
	(b) <b>Standards on Review Engagements (SREs)</b> : to be applied in review of historical financial information.
	(c) <b>Standards on Assurance Engagements (SAEs)</b> : to be applied in assurance engagements dealing with subject matter other than historical financial information.
	(d) <b>Standards on Related Services (SRRs)</b> : to be applied to engagements involving application of agreed upon procedures to information and other related services such as compilation engagements.

<b>Numbering of Standards</b>	
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
<b>Classification of SAs</b>	
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
<b>Standards on Auditing (SAs)</b>	
❖ SAs apply in the context of an audit of F.S. by an independent auditor.	
❖ These Standards <b>establish high quality benchmarks</b> and are followed by auditors in conducting audit of Historical Financial Information contained in F.S.	
❖ SAs have been issued on various matters in field of auditing like overall objectives of independent auditor, audit documentation, planning an audit, identifying & assessing risk of material misstatement (RoMM), audit sampling, audit evidence & forming an opinion and reporting on F.S.	
❖ <b>Examples of SAs are:</b>	
(a) <b>SA 200:</b>	Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing.
(b) <b>SA 230:</b>	Audit Documentation.
(c) <b>SA 315:</b>	Identifying & Assessing Risks of Material Misstatement through Understanding the Entity and its Environment.
(d) <b>SA 500:</b>	Audit Evidence.
(e) <b>SA 700:</b>	Forming an Opinion and Reporting on Financial Statements

**Standards on Review Engagements (SRE)**

- SRE apply in the context of review of F.S.
- Review is **limited assurance** engagement & provides **assurance lower** than the assurance **provided by audit** as it involves fewer procedures as compared to audit.
- Since review also provides assurance to users, it also involves obtaining sufficient appropriate evidence.
- **Examples of SREs** are:
  - (a) **SRE 2400:** Engagements to Review Historical Financial Statements.
  - (b) **SRE 2410:** Review of Interim Financial Information Performed by Independent Auditor of the Entity

Note: Both SAs and SREs apply to engagements involving historical financial information.

**Standards on Assurance Engagements (SAE)**

- 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:
  - (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)**

- SRSs apply in case of **Non-Assurance Engagements**. Examples of such related services include engagements to perform agreed-upon procedures & 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 F.S.



- In **Compilation engagement**, practitioner is required to assist mngt. with preparation & 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.

- **Examples of Standards on related services** are:

(a) **SRS 4400:** Engagements to perform agreed-upon procedures regarding financial information.

(b) **SRS 4410:** Compilation engagements.

### **Duties in relation to Engagement and Quality Control Standards**

- It is duty of professional accountants to see that Standards are followed in engagements undertaken by them.

- However, a situation may arise when a **specific procedure as required in Standards would be ineffective** in a particular engagement. In such case, professional accountant is required to ensure the following:

(a) **Document how alternative procedures performed** to achieve purpose of required procedure;

(b) **Reason for departure** has also to be documented;

(c) Report should **draw attention to such departures**.

Note: A mere disclosure in report does not absolve a professional accountant from complying with applicable Standards

**DO PRACTICE - Questions from Cracker (Question Bank)**