

# Chapter 1: NATURE, OBJECTIVE AND SCOPE OF AUDIT

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## 1. Origin of Audit

- ✓ Auditing existed in ancient civilizations, including India. **Kautilya's Arthashastra (4th century BC)** referred to a fixed accounting year, account closures, Audits, and financial misstatements due to power abuse.
- ✓ The term "Audit" comes from the Latin word "**audire**", meaning "**to hear.**" In medieval times, Auditors listened to accounts being read out to verify accuracy and prevent negligence.
- ✓ The Industrial Revolution in Europe led to rapid trade expansion, increasing the need for Auditors to ensure financial accuracy and accountability.
- ✓ British India appointed its first **Auditor General** in 1860, handling both accounting and Auditing responsibilities, marking the beginning of formal Auditing in the country.
- ✓ The **Comptroller and Auditor General of India (CAG)** later became a statutory and Independent constitutional authority responsible for Auditing government revenues and expenditures.
- ✓ The **Institute of Chartered Accountants of India (ICAI)** was established under an Act of Parliament in 1949 to regulate the Chartered Accountancy profession in India.

### Quick Summary

**Arthashastra, audire = "to hear.", Auditor General in 1860, CAG, ICAI**

## 2. Audit- Mandatory or Voluntary?

Audit **may be mandatory** for certain entities, like companies and businesses crossing tax threshold limits. Some entities, like schools, require Audits for government grants. However, **Audit is not always compulsory**—many organizations opt for voluntary Audits due to their benefits. Internal policies may also mandate Audits for better accountability.

## 3. Who Appoints an Auditor?

- ✓ Auditor is appointed by **owners** or in some cases by **constitutional or government authorities** in accordance with applicable laws and regulations.
- ✓ In case of a **company** Auditor is appointed by **Shareholders** of the company
- ✓ In case of a **firm** Auditor is appointed by **partners** of firm.

## 4. To Whom Report is Submitted by an Auditor?

The Report is submitted to **person making the appointment**. In case of companies, these are shareholders in case of a firm, to partners who have engaged him.

## 5. Meaning and Nature of Auditing

"An 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 thereon**".

Analysis of definition

- ❖ Audit is an **independent examination** of financial information.
- ❖ The **entity** whose financial information is examined **need not necessarily be profit oriented** like in case of a business.
- ❖ 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**.
- ❖ The **purpose** of Audit is to **express an opinion** on the financial statements.

Quick Revision

- ↪ Audit = **Independent Examination** of Financial Information +
- ↪ Of **any entity** profit oriented or not irrespective of size or legal form +
- ↪ Conducted to **Express an opinion** of such Financial Information

In doing so, **Auditor must** ensure that financial statements would not mislead anybody by ensuring that:

- ❖ The **accounts** have been **drawn up** with reference to **entries in the books** of account.
- ❖ The **entries** in the books of account are adequately **supported by sufficient and appropriate evidence (SAAE)**.
- ❖ **None of the entries** in the books of account 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** as per applicable financial Reporting framework (**AFRF**); and
- ❖ The **statement of accounts** presents a **true and fair picture** of the **operational results and of the assets and liabilities**.

Student notes

Quick Revision		
a	Entries	Accounts drawn with reference to them
b		Supported by SAAE
c		Not Omitted
d	Financial Statements	Information Clear and Unambiguous
e		Amounts are properly classified, described and disclosed.
f	Statement of accounts	Gives true and fair picture

## 6. Interdisciplinary Nature of Auditing

**Auditing and Accounting:** Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

**Auditing and Law:** An Auditor should have a good knowledge of business laws affecting the entity.

**Auditing and Economics:** Auditor is expected to be familiar with the overall economic environment of the client.

**Auditing and Behavioural Science:** Knowledge of human behaviour is essential for an Auditor to effectively discharge his duties.

**Auditing and Statistics & Mathematics:** Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.

**Auditing and Data Processing:** EDP Auditing is developing as a discipline in itself.

**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.

**Auditing and Production:** Good Auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

Student notes

## 7.SA-200 “Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with Standards on Auditing”

### Overview of SA 200

Objectives of Auditor	Scope of Audit What is included and not	Inherent limitations of the Audit
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### 7.1 Objectives of Auditor

In conducting Audit of financial statements, objectives of Auditor in accordance with SA-200 “Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with Standards on Auditing” are: -

(a) 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 on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial Reporting framework (AFRF); and

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

#### Analysis of Objective

- ❖ Auditor's objective is to obtain a Reasonable Assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error.
  - Reasonable Assurance is not a complete guarantee. Although it is a high-level of Assurance, but it is not complete Assurance.
- ❖ Misstatements in financial statements can occur due to fraud or error or both.
- ❖ Express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial Reporting framework.
- ❖ The opinion is Reported and communicated in accordance with Audit findings through a Written Report as required by Standards on Auditing.

#### Quick Revision

Obtain R.A. that FS are free from MM due to fraud or error  
Report and communicate as per SA's

## 7.2 Scope of Audit

Scope refers to **range or reach** of something.

The following points **are included** in scope of Audit of financial statements: -

(a) Coverage of all aspects of entity:

- ❖ Audit of financial statements should be **organized adequately to cover all aspects of the entity** relevant to the financial statements being Audited.

(b) Reliability and sufficiency of Financial information

- ❖ The Auditor should be **reasonably satisfied** that information contained in underlying **accounting records and other source data** (like bills, vouchers, documents etc.) is **reliable and sufficient** basis for preparation of financial statements.
- ❖ The Auditor makes a **judgment of reliability and sufficiency** of financial information by making a **study and assessment of accounting systems and internal controls** and by carrying out appropriate tests, enquiries and procedures.

(c) Proper disclosure of financial information:

- ❖ Auditor should also decide whether **relevant information** is **properly disclosed** in the financial statements. He should also keep in mind applicable statutory requirements in this regard.
- ❖ It is **done by ensuring** that financial statements properly **summarize transactions and events** recorded therein and by **considering the judgments made by management** in preparation of financial statements.
- ❖ The Auditor **evaluates selection and consistent application of accounting policies** by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

(d) Historical financial information:

- ❖ Financial statements are prepared based on historical financial information. Therefore, Audit of financial statements is based upon historical financial information.

"Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

The following are not included in the scope of Audit: -

- (a). Responsibility of preparation and presentation of financial statements.
- (b). Auditor is not expected to perform duties that fall outside the domain of competence.
- (c). Auditor is not an expert in authentication of documents.
- (d). Audit is not an official Investigation.

Include in Audit	Not included in Audit
Coverage of all aspects of entity	Outside domain of competence
Reliability and Sufficiency of financial information	Preparation and Presentation of financial statements
Proper disclosure of financial information	Not expert in authentication of documents
Historical financial information	Not an official Investigation

### 7.3 Inherent limitations of the Audit

The Auditor is not expected to and cannot reduce Audit risk to zero and cannot therefore provide absolute Assurance that the financial statements are free from material misstatement whether due to fraud or error. This is due to Inherent limitations of the Audit. These fundamental limitations arise due to the following factors: -

#### (1). Nature of financial Reporting

- ❖ Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, Auditor may not be able to obtain absolute Assurance that financial statements are free from material misstatements due to frauds or errors.
- ❖ Management design Internal controls, such Internal controls may not operate to provide reliable financial information due to their own limitations.

#### (2). Nature of Audit procedures

- ❖ The Auditor carries out his work by obtaining Audit evidence through performance of Audit procedures. However, there are practical and legal limitations on ability of Auditor to obtain Audit evidence.
- ❖ **Practical Limitations:** an Auditor does not test all transactions and balances. He forms his opinion only by testing samples.

- ❖ **Legal Limitations:** Management may not provide complete information as requested by Auditor. There is no way by which Auditor can force management to provide complete information as may be requested by Auditor. In case he is not provided with required information, he can only Report.
- ❖ The management may consist of **dishonest and unscrupulous** people and may be, itself, involved in fraud. It may be engaged in **concealing fraud** by designing **sophisticated** and **carefully organized schemes** which may be hard to detect by the Auditor.
- ❖ It is quite possible that entity may have **entered** some transactions with **related parties**. The Auditor may not be aware of such related party relationships or Audit procedures may not be able to detect probable wrong doings in such transactions.

### (3). Not in the nature of official Investigation: -

- ❖ Audit is not an official Investigation. Hence, Auditor cannot obtain absolute Assurance that financial statements are free from material misstatements due to frauds or errors.

### (4). Timeliness of Financial Reporting and decrease of relevance of information over time:

- ❖ The **relevance** of information **decreases** over time and 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**. The 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

Student notes



### Quick Revision

#### The Nature of Financial Reporting:

The preparation of financial statements involves judgment by management.

#### The Nature of Audit Procedures:

There are **practical and legal limitations** on the Auditor's ability to obtain Audit evidence such as:

Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.

**Fraud** may involve sophisticated and carefully organised schemes.

#### Not in the nature of Investigation:

An Audit is **not an official Investigation** into alleged wrongdoing.

#### Timeliness of financial Reporting and decrease in relevance of information over time:

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.

#### Future events:

Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its Business.

### 8. Benefits of Audit

1. Audited accounts provide **high quality information**.
2. Helps in **safeguarding of interest of shareholders**.
3. Acts as a **moral check on employees** from committing frauds for the fear of being discovered by Audit.
4. Audited financial statements are **helpful to government** authorities for **determining tax liabilities**.
5. Audited financial statements can be **relied upon by lenders**, bankers for making their credit decisions.
6. An Audit **may also detect fraud or error or both**.
7. An Audit **reviews existence and operations of various controls** operating in any entity. Hence, it is useful at pointing out deficiencies.

### Quick Revision

**High Quality information**

**Moral check**

**Relied upon by bankers**

**Safeguards Interest**

**Determining tax liability**

**Detect fraud or error**

**Reviews Existence and Operations of Internal controls**

## 9. What is an Assurance Engagement

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

### 9.1 Elements of Assurance Engagement

#### 1. A three-party relationship involving a practitioner, a responsible party, and intended users

- ❖ A practitioner is a person who provides the Assurance. Practitioner is broader than Auditor. Audit is related to historical information whereas practitioner may provide Assurance not necessarily related to historical financial information.
- ❖ A responsible party is the party responsible for preparation of subject matter.
- ❖ Intended users are the persons for whom an Assurance Report is prepared. These persons may use the Report in making decisions.

#### 2. An appropriate subject matter

- ❖ Refers to the information to be examined by the practitioner.

#### 3. Suitable criteria

- ❖ Refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

#### 4. Sufficient appropriate evidence

- ❖ The practitioner performs an Assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions arrived, and an opinion is formed by Auditor.

#### 5. A Written Assurance Report in appropriate form

- ❖ A Written Report is provided containing conclusion that conveys the Assurance about the subject matter it is the outcome of Assurance engagement.

#### Student notes

Quick Revision	
Three party relationship	Between practitioner, a responsible party, and intended users
subject matter	Information to be Examined
Suitable criteria	Benchmarks used to examine
Sufficient appropriate evidence	Evidence obtained to reach conclusion
A Written Assurance Report in appropriate form	Report containing conclusion of the engagement

## 9.2 Review v/s Audit

A Review is a Limited Assurance engagement, it provides lower level of Assurance than Audit.

Basis	Review	Audit
Level of Assurance	Limited Assurance	Reasonable Assurance
Audit Procedures	Fewer Audit procedures	Extensive and Elaborate Procedures
Information Tested	Historical Information	Historical Information

## 9.3 Reasonable Assurance engagement vs Limited Assurance engagement

Basis	Reasonable Assurance engagement	Limited Assurance engagement
Assurance	Provides high level of Assurance.	Lower level of Assurance than Reasonable Assurance engagement.
Audit Procedures	Performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	Performs fewer procedures as compared to Reasonable Assurance engagement.
Conclusion	Draws Reasonable conclusions based on sufficient appropriate evidence.	Involves obtaining sufficient. appropriate evidence to draw. Limited conclusions.
Example	Audit engagement.	Review engagement.

## 9.4 Prospective financial information

"Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both.

- ❖ It is not an Assurance that is related to historical financial statements.
- ❖ Practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not Unreasonable, the prospective financial information is properly prepared on the basis of the assumptions, and it is properly presented, and all material assumptions are adequately disclosed.
- ❖ The Auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved. Therefore, practitioner provides a Report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a Reasonable basis for the projection.
- ❖ Hence, such type of Assurance engagement provides only a "moderate" level of Assurance.

Quick revision					
Not related to Historical Financial information	Obtain SAAE on Management assumptions	Whether they are not Unreasonable	And adequate disclosure of material assumptions	Auditor is not able to express opinion	Provides moderate level of Assurance

## 10. QUALITIES OF AUDITOR

An Auditor 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.

- ❖ Tact, caution, firmness, good temper, integrity, discretion, industry judgement, patience, clear headedness and reliability are some of qualities which an Auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good Auditor.
- ❖ In addition, he must have the shine of culture for attaining a great height.
- ❖ He must have the highest degree of integrity backed by adequate independence.

- ❖ 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.
- ❖ An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of Auditing. He must know thoroughly all accounting principles and techniques.

## *11. Engagement and Quality control Standards*

### 1. Standards on Auditing (SAs)

- ❖ Apply in Audit of historical financial information.
- ❖ Apply in the context of Audit of financial statements by Independent Auditor.
- ❖ These establish high quality benchmarks and are followed by Auditors in conducting Audit of financial statements.
- ❖ Ex: SA 200, SA 230, SA 315, SA 500, SA 700

### 2. Standards on Review Engagements (SREs)

- ❖ Apply to Review engagement related to Historical financial information.
- ❖ It is Limited Assurance engagement standard.
- ❖ It is due to review involves fewer procedures as compared to Audit.
- ❖ Ex: SRE 2400, SRE 2410

### 3. Standards on Assurance Engagements (SAEs)

- ❖ Apply to Assurance engagement related to matters other than Historical financial information.
- ❖ It does not include "Audit" or "review" of historical financial information.
- ❖ 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.
- ❖ Ex: SAE 3400, SAE 3420

### 4. Standards on Related Services (SREs)

- ❖ These standards apply in engagements to perform agreed-upon procedures regarding financial information.
- ❖ An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining Assurance on that information.
- ❖ Ex: SRS 4400, SRS 4410

## 5. Standards on Quality Control (SQC)

- ❖ Issued to **establish standards** and **provide guidance** regarding a firm's responsibilities for its system of **quality control** for the conduct of **Audit and review** of historical financial information and for other Assurance and related service engagements.
- ❖ **SQC 1** has been issued in this regard.
- ❖ It requires **Auditors/practitioners** to
  - **Establish system of quality control** so that firm and its personnel **comply** with professional standards and regulatory & legal requirements and
  - **Reports** issued are **appropriate**.

### 11.1 Why are Standards Necessary?

1. Standards **ensure** carrying out of Audit against **established benchmarks** at par with global practices.
2. Standards **improve quality** of financial Reporting thereby helping **users** to make **diligent decisions**.
3. Standards **promote uniformity** as Audit of financial statements is carried out following these Standards.
4. Standards equip professional accountants with **professional knowledge and skill**.
5. Standards **ensure Audit quality**.

#### Quick Revision

Audit in accordance with <b>Benchmarks</b>	Improve <b>quality of FR</b> , helps users in decision making	Promote <b>uniformity</b> (Comparability)	Provide accountants <b>knowledge and skills</b>	Audit <b>Quality</b>
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#### Student notes