



# NATURE, OBJECTIVE AND SCOPE OF AUDIT



## LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the functional classification and qualities of an auditor.
- ❑ Define audit and understand the objectives of audit, principles governing audit etc.
- ❑ Distinguish between auditing and investigation.
- ❑ Understand different types of audit and relationship of auditing with other disciplines.

## CHAPTER OVERVIEW





## 1. MEANING AND 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."

### Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

**The person conducting this task should take care to ensure that financial statements would not mislead anybody.** This he can do honestly by satisfying himself that:

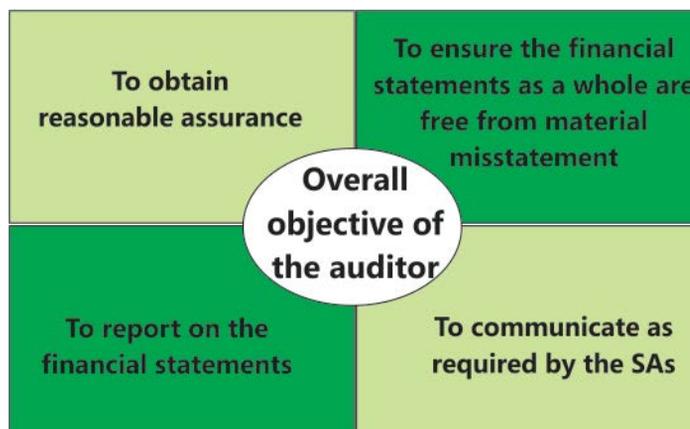
- (i) the accounts have been drawn up with reference to entries in the books of account;
- (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
- (iv) the information conveyed by the statements is clear and unambiguous;
- (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- (vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.



## 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:

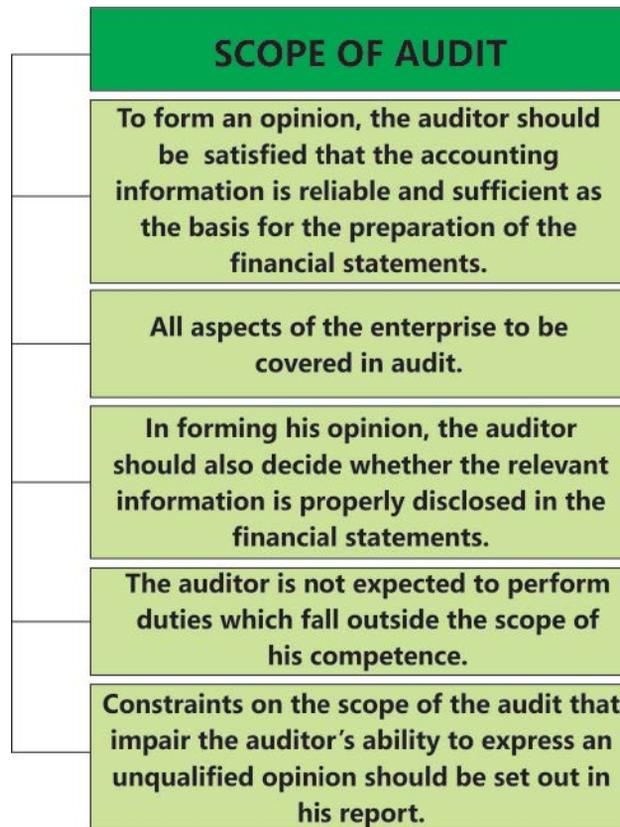
- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement ; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.



### 3. SCOPE OF AUDIT

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

1. The audit should **be organized to cover adequately all aspects of the enterprise** relevant to the financial statements being audited.
2. 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 and other source data is reliable** and sufficient as the basis for the preparation of the financial statements.
3. In forming his opinion, the auditor should also **decide whether the relevant information is properly disclosed in the financial statements** subject to statutory requirements, where applicable.
4. **The auditor assesses the reliability and sufficiency of the information** contained in the underlying accounting records and other source data 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 in the particular circumstances.
5. **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 therein; and



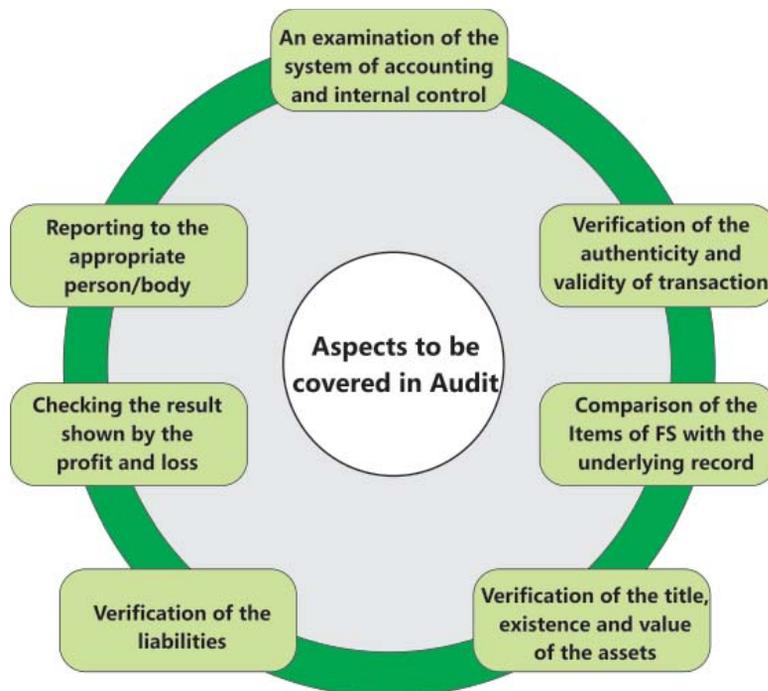
(b) **considering the judgments that management has made in preparing the financial statements** accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

6. **The auditor is not expected to perform duties which fall outside the scope of his competence.** For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.
7. **Constraints on the scope of the audit** of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement 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

The principal aspects to be covered in an audit concerning final statements of account are the following:

- (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 incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (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 into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.
- (vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.

**Assertions about account balances at the period end:**

- (a) **Existence**—assets, liabilities, and equity interests exist.
  - (b) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
  - (c) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.
  - (d) **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- (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 do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

**Definition of Assertions:** It refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

**(Note:** For detailed discussion on assertions, students may refer Chapter 3- Audit Documentation and Audit Evidence)



## 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.e., audit required under law and voluntary audits.**

- (i) **Audit required under law:** The organisations which require audit under law are the following: e.g companies governed by the Companies Act; banking companies; other statutory bodies required by their regulators or by specific Act.
- (ii) **In the voluntary category** are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives 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. Government companies have some special features which will be seen later.

As already stated, the auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. Also it is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made. Furthermore, to ensure that the report will be brought to the notice of all concerned, the accounts should bear reference to the report.

A special reference is necessary for non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income. What makes them distinct, is the absence of the question of division of profit: any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

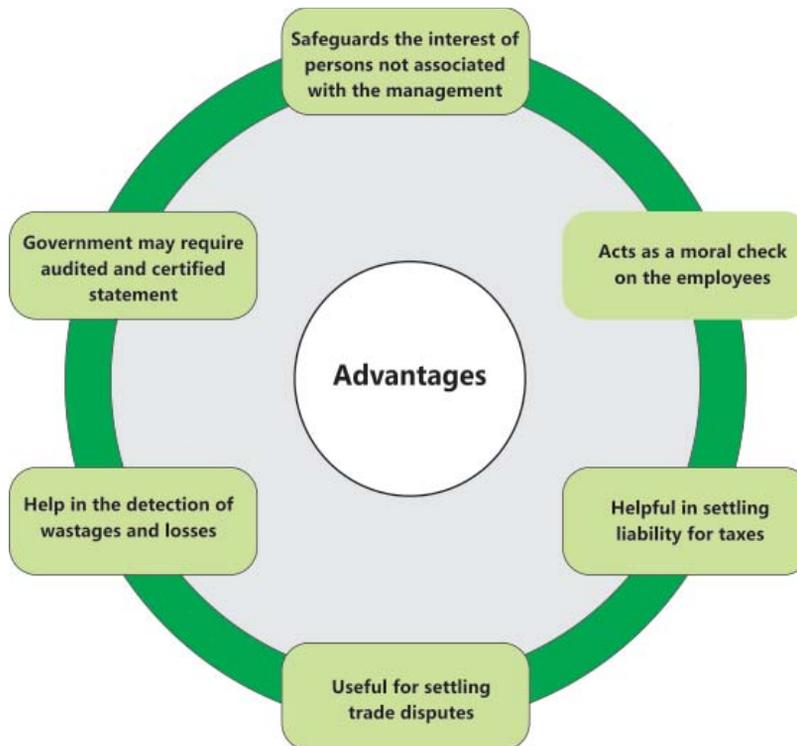
Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts are of the supreme importance are often widows and minors, who cannot criticize the accounts in any effective manner. Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contain a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.



## 5. ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

- (a) **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.
- (b) **It acts as a moral check on the employees** from committing defalcations or embezzlement.



- (c) Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.
- (d) 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.
- (e) An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
- (f) **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.
- (g) As an appraisal function, **audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.
- (h) Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner**.
- (i) **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 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing",

*The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the 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 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.
- (ii) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
  1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
  2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. **Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, 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.
  3. 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 the 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.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. 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.

- (iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:
- Fraud, particularly fraud involving senior management or collusion.
  - The existence and completeness of related party relationships and transactions.
  - The occurrence of non-compliance with laws and regulations.
  - Future events or conditions that may cause an entity to cease to continue as a going concern.

### ILLUSTRATION

*MNO Ltd requested the auditor CA P to provide for absolute assurance in respect of its ten branches scattered in Delhi and confirm that the financial statements are free from material misstatement due to fraud or error. Advise.*

### SOLUTION

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

In view of the above, CA P cannot provide audit absolute assurance to MNO Ltd in respect of its branches.

**Inherent Limitations of Audit** (SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"): The auditor is not expected to, and cannot, reduce audit risk to zero because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

**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.

An audit is not an official investigation into alleged wrongdoing.

**Timeliness of Financial Reporting and the Balance between Benefit and Cost:**

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 the Limitations of an Audit:** Certain assertions or subject matters are particularly significant, such assertions or subject matters include:

- |  |  |
|--|--|
| <ul style="list-style-type: none"> <li>• Fraud, particularly involving senior management or collusion.</li> <li>• The existence and completeness of related party relationships and transactions.</li> </ul> | <ul style="list-style-type: none"> <li>• The occurrence of non-compliance with laws and regulations.</li> <li>• Future events or conditions that may cause an entity to cease to continue as a going concern.</li> </ul> |
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**ILLUSTRATION**

*DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2015-2016. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor.*  
*Comment.*

**SOLUTION**

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.



## 7. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

The field of auditing as a discipline in simple words involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that 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.



**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 in itself is developing as a discipline in itself.

**Auditing and Financial Management :** the 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.

## 7.1 Auditing and Accounting

It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

## 7.2 Auditing and Law

The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that 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 is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

## 7.3 Auditing and Economics

As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. 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. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

## 7.4 Auditing and Behavioural Science

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that 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.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. However, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

## 7.5 Auditing and Statistics & Mathematics

With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure,

discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of 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.

### **7.6 Auditing and Data Processing**

Today, organisations are witnessing revolution in the field of data processing of accounts. 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. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, Computerised Information System auditing in itself is developing as a discipline in itself.

### **7.7 Auditing and Financial Management**

Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. 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.

### **7.8 Auditing and Production**

Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, 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. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.



## 8. STANDARD SETTING PROCESS

### 8.1 Role of International Auditing and Assurance Standards Board

In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

**International Auditing and Assurance Standards Board (IAASB):** The IFAC Board has established the IAASB to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IAASB functions as an independent standard-setting body under the auspices of IFAC.

**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.

## 8.2 Role of Auditing and Assurance Standards Board

The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the applicable laws, customs, usages and business environment in India. In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of SAPs had also been changed to Auditing and Assurance Standards (AASs).

A major development in the field of auditing has been the issuance of revised and /or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

**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.

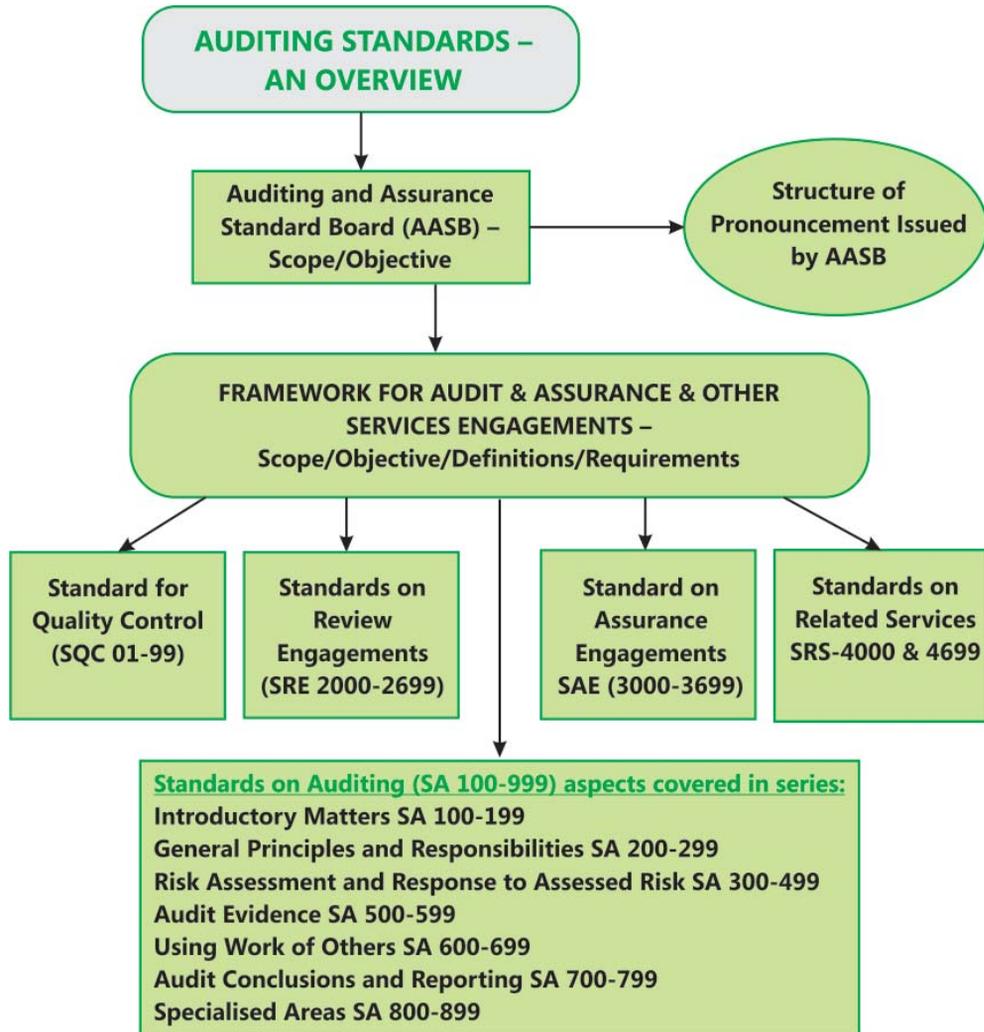
**SAEs**

apply in assurance engagements, dealing with subject matters other than historical financial information.

**SRSSs**

apply to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.

### Diagrammatic Representation of the Structure of Standards Under the New Preface



These Standards will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

While discharging their attest function, it will be the duty of members of the Institute to ensure that the Standards are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the Standards, his report should draw attention to the material departures therefrom, auditors will be expected to follow Standards in the audits commencing on or after the date specified in the statement. Remember all Standards

are mandatory from the date mentioned herein and it is obligatory upon members of Institute to adhere to these whenever an audit is carried out.

All relevant Standards which are important from students' view point have been covered as an integral part of the text.

**Compliance with Documents Issued by the Institute:** The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make **adequate disclosures in their audit reports** so that the users of financial statements may be aware of such deviations; and
- (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the **material departures**, therefrom.

**'Guidance Notes'** : are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are however a few guidance notes in case of which the Council has specifically stated (discussed in Announcements part reproduced in Handbook on Auditing Pronouncements) that they should be considered as mandatory on members while discharging their attest function.



## 9. QUALITIES OF AN AUDITOR

It is not enough to realise what an auditor should be. 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 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. 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 law which govern matters with which he is likely to be in intimate contact. **The Companies Act** need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical 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 for the development of professional competence of an auditor for undertaking any kind of audit assignment.

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. 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.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly 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

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 "Quality Control for an Audit of Financial Statements", the 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.

**Engagement partner** refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

### 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. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

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 behavior.

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.

The auditor's independence safeguards the auditor's ability to form an audit opinion without being affected by any influences. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Standard on Quality Control (SQC) 1 sets out the responsibilities of the firm for establishing policies and procedures regarding compliance with relevant ethical requirements.

SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements. SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures.

### 10.2.1 Independence of Auditors

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. 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. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. 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, one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

**"Independence is: (a) Independence of mind** – the 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 exist to all reasonable persons.**

The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity.

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

### 10.2.2 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:**

1. **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. **Advocacy threats**, which occur when the auditor promotes, or is perceived to promote, 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.

4. **Familiarity threats** 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: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. **Intimidation threats**, which occur when auditors are deterred 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 disproportionately reduce work in response to reduced audit fees.

### 10.2.3 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: -

1. 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.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

### 10.2.4 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.

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

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.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

### **10.3 Acceptance and Continuance of Client Relationships and Audit Engagements**

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed:

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.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

#### 10.4 Human Resources

The firm should establish **policies and procedures** designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

**Such policies and procedures address the following personnel issues:**

- (a) Recruitment;
- (b) Performance evaluation;
- (c) Capabilities;
- (d) Competence;
- (e) Career development;
- (f) Promotion;
- (g) Compensation; and
- (h) 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. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

### 10.5 Engagement Performance

The firm should establish **policies and procedures** designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

**Through its policies and procedures**, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or electronic manuals**, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. 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 firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

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

- (a) Adherence to professional standards and regulatory and legal requirements;

- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
- (c) 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. PRECONDITIONS FOR AN AUDIT

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.



In order to establish whether the preconditions 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. AGREEMENT ON AUDIT ENGAGEMENT TERMS

Legal requirement to get the accounts audited so far extends only to companies, registered societies etc. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. **It is, therefore important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.** The audit engagement letter is sent by the auditor to his client. The ICAI has issued SA 210 "Agreeing the Terms of Audit Engagements" on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

**In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed.** The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid.

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:

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) 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 sufficient 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 and that management acknowledges and understands its responsibilities.



## 13. RECURRING AUDITS

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

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.

### ILLUSTRATION

*R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients for last 5 years despite changes in business and professional environment.*

#### **Required**

*Elucidate the circumstances that may warrant the revision in terms of engagement.*

### SOLUTION

As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the factors that may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms are discussed in para 14 above.



## 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.

**Analysis**

- If management or TCWG
- impose limitation on the scope
- such that auditor believes
- limitation would result in
- auditor disclaiming an opinion
- the auditor shall not accept such a limited engagement

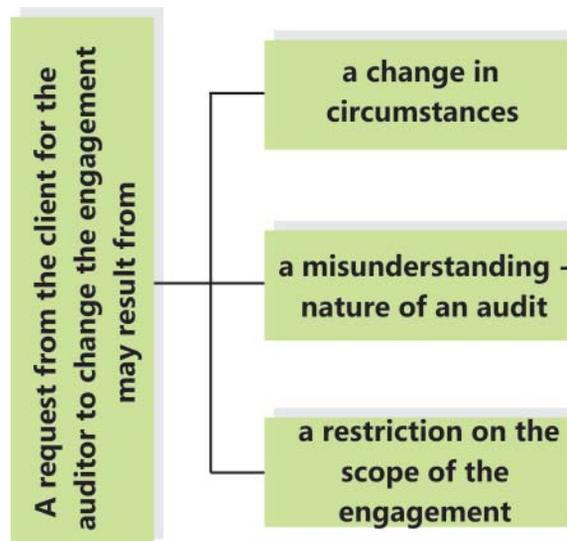


## 15. ACCEPTANCE OF A CHANGE IN ENGAGEMENT

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-

1. a **change in circumstances** affecting the need for the service,
2. a **misunderstanding** as to the nature of an audit or related service originally requested.
3. 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. In order to avoid confusion, the report would not include reference to:

- (a) the original engagement; or
- (b) any procedures that may have been performed in the original 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.

### ILLUSTRATION

*M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29<sup>th</sup> May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh.*

### Required

*State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.*

### SOLUTION

Relying on Work Performed by Another Auditor: As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent

of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.



## CASE STUDY

Mr. Veeru of Delhi has started a new business of selling of Handloom items. He purchases these items from a factory situated in Ludhiana and sells to local customers at a price which gives him reasonable amount of profit. All gets well in the first year and he earns some income from the business.

However, he feels that he could expand this business if he was able to bring more items to the place where he sells them and also he is aware of the fact that there are several other locations as well where he could sell these items. He could achieve this by buying a van and by employing other people who will assist him in his business on the other locations.

He needs more money to achieve this expansion of his business. He decides to ask his friend Raju to invest in the business.

Having seen the potential of Veeru's business, Raju wants to invest, but neither he wants to manage nor wants to have ultimate liability for the debts of the business in case business fails. He therefore suggested that they should set up a proprietary firm. He will be the owner of the firm and will be entitled to profits. On the other hand, Veeru would be the Manager and be paid a salary.

At the end of the first year of trading when Raju receives copy of the financial statements, he finds that Profits are much lower than what was expected. Raju knows that Veeru is paid salary so he may not care for low profits. Raju is concerned by the level of profits and feels that he wants further assurance on the accounts. He does not know whether the accounts give a true and fair view of the last year's trading because the profits do not seem as high as those Veeru had predicted when he agreed to invest.

Raju seeks solution for his problem.

The solution is that the assurance Raju is seeking may be given by an Independent Audit of accounts.



## SUMMARY

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. The person conducting this task should take care to ensure that financial statements would not mislead anybody. As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and to report on the financial statements. The auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics.

The auditor shall comply with relevant ethical requirements including those pertaining to independence. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. The Code establishes the five 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 behavior.



## TEST YOUR KNOWLEDGE

### MCQs

- along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession.
  - Auditing
  - Taxation
  - Finance
  - Taxation and Finance both
- No business or institution can effectively carry on its activities without the help of proper ----- :
  - Audit
  - Record and accounts
  - neither (a) nor (b)
  - both (a) and (b)
- As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:
  - To obtain reasonable assurance
  - To report on the financial statements
  - Both (a) and (b) above
  - none of the above
- (IESBA Code) related to an audit of financial statements establishes which of the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :
  - Integrity;
  - Objectivity;
  - Professional competence and due care;
  - All of the above
- The auditor's \_\_\_\_\_ safeguards the auditor's ability to form an audit opinion without being affected by any influences.
  - Objectivity

- (b) Independence
- (c) Confidentiality
- (d) Integrity

### Correct / Incorrect

**State with reasons (in short) whether the following statements are correct or incorrect:**

- (i) The basic objective of audit does not change with reference to nature, size or form of an entity
- (ii) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.
- (iii) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.
- (iv) The audit engagement letter is sent by the client to auditor.
- (v) Specific disclosure is required of the fundamental accounting assumptions followed in the financial statements.

### Theoretical Questions

1. Explain clearly meaning of Auditing. How would you as an auditor perform the audit.
2. "The independent audit of an entity's financial statements is a vital service to investors, trade payables, and other participants in economic exchange." Explain
3. State the objectives of Audit according to SA 200
4. "The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats." Explain

## ANSWERS/SOLUTIONS

### Answers to MCQs

1. (a)      2. (b)      3. (c)      4. (d)      5. (b)

### Answers to Correct/Incorrect

- (i) **Correct:** 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. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

- (ii) **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- (iii) **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.
- (iv) **Incorrect:** As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.
- (v) **Incorrect,** as per AS 1, "Disclosure of Accounting Policies", specific disclosure of the fundamental accounting assumption is required if they are not followed in the financial statements.

### Answers to Theoretical Questions

1. Refer 1: Meaning and Definition of Auditing.
2. Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different points of time with numerous persons and entities. The effect of all transactions has to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organisation. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organisation or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which

ensures that the accounting statements are authentic. In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, trade payables, and other participants in economic exchange.

3. Refer para 2 : Overall Objectives of Audit.
4. Refer para 11.2.2 : Threats to Independence

