

# 1

## CHAPTER

# Nature, Objective and Scope of Audit

### 1.1 - Meaning, Objectives and Scope of Audit

#### Meaning of Audit

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.

This definition has the following implications:

- (a) Audit is independent examination.
- (b) Examination is of financial information when the objective is to express an opinion.
- (c) Requirement of audit applies in case of every entity, whether profit oriented or not (Commercial entities or NGOs), whatever is the business size of entity (Small Size entity or large size entity), whatever is the legal form of the entity (proprietor, partnership or company).

#### Points to be ensured that F.S. not misled anybody

Auditor engaged to perform the task of performing audit need to ensure the following:

- (a) Ledger balances agree with the entries made in the books of account.
- (b) Sufficient and Appropriate evidences are available for entries made in books of account.
- (c) All transactions are being recorded in books of account, i.e. there is no omission.
- (d) Information contained in the financial statements is clear and unambiguous.
- (e) Amounts shown in financial statements are properly classified, described and disclosures are made in conformity with applicable Accounting Standards.
- (f) Financial statements reflect true and fair view of financial results and financial position

#### Objectives of Audit

- (a) The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to **express an opinion** on such financial statements.
- (b) The auditor's opinion helps determination of the **true and fair view** of the financial position and operating results of an enterprise.
- (c) The user, however, 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.

	(d) Auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.	
<b>Objectives of Auditor</b>	Covered in SA 200	
<b>Scope of Audit</b>	<p>The scope of audit is determined by the auditor having regard to following:</p> <p>(a) Terms of the Audit Engagement</p> <p>(b) Requirement of Relevant Statute.</p> <p>(c) Pronouncements of the ICAI.</p> <p>However, the terms of engagement cannot supersede the requirements of statute or pronouncements of ICAI.</p>	
<b>Points to be considered in determining Scope of Audit</b>	<ol style="list-style-type: none"> <li>1. Audit should cover the examination of all aspects of an entity relevant to financial statements.</li> <li>2. Auditor should assess the sufficiency and appropriateness of the information contained in the accounting records and other source data. For this purpose, auditor should             <ol style="list-style-type: none"> <li>(a) evaluate accounting systems and internal controls</li> <li>(b) perform necessary tests, enquiries and other verification procedure of accounting transactions and account balances.</li> </ol> </li> <li>3. To determine whether the information is properly disclosed in the financial statements, audit may involve             <ol style="list-style-type: none"> <li>(a) comparing the financial statements with the underlying records</li> <li>(b) considering the judgements used by management in preparing the financial statements.</li> </ol> </li> <li>4. Auditor is not expected to perform duties which fall outside the scope of his competence.</li> <li>5. Limitations, if any, on the scope of audit that impair the auditor's ability to express an unmodified opinion should be set out in his report.</li> </ol>	
<b>Aspects to be covered in Audit</b>	<b>Examination of Accounting System &amp; Internal Control</b>	<ul style="list-style-type: none"> <li>◆ To ascertain whether it is appropriate for the business and helps in proper recording of all the transactions.</li> <li>◆ To determine the Nature, Timing and Extent (NTE) of Audit Procedures to be performed.</li> </ul>
	<b>Reviewing the system &amp; procedures</b>	<ul style="list-style-type: none"> <li>◆ To find out whether they are adequate and comprehensive.</li> </ul>
	<b>Vouching of the transactions</b>	<ul style="list-style-type: none"> <li>◆ To ensure authenticity and validity of transactions.</li> <li>◆ To check the arithmetical accuracy of the books of account.</li> </ul>

			◆ To ascertain proper distinction into capital and revenue items.
		<b>Verification of Assets &amp; Liabilities</b>	◆ To ensure existence and valuation of the assets and liabilities appearing in the balance sheet.
		<b>Statutory Compliances</b>	◆ In case of entities governed by some law, rules or regulations, for example in case of audit of a company incorporated under Companies Act, 2013.
		<b>Expression of Opinion</b>	<ul style="list-style-type: none"> <li>◆ On true and fair view of state of Affairs as reflected by Balance Sheet.</li> <li>◆ On true and fair view of Financial Results as reflected by Statement of Profit and Loss.</li> <li>◆ On true and fair view of Cash Flows as reflected by Cash Flow Statement.</li> </ul>
		<b>Reporting on Other matters</b>	As required by the law governing the entity.

### Important Questions

**Q. No. 1: The person conducting the audit should take care to ensure that financial statements would not misled anybody. Describe briefly the points the auditor should ensure for.**

**Q. No. 2: The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.**

Or

State the objectives of Audit according to SA 200

**Q. No. 3: List the points that merit consideration in regard to scope of audit.**

**Q. No. 4: State briefly six important aspects to be considered by an auditor while conducting an audit.**

or

State the matters which the statutory auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall audit approach.

or

State the principal aspects to be covered in an audit concerning financial statement of account.

[Nov. 15 (5 Marks)]

**Q. No. 5: The duties of the auditor are limited to verification of the arithmetical accuracy of the books of the account. Comment.**

### 1.2 - Types of Audit

<b>Audit required under law</b>	<ul style="list-style-type: none"> <li>(a) Companies governed by the Companies Act, 2013;</li> <li>(b) Banking companies governed by the Banking Regulation Act, 1949;</li> <li>(c) Electricity supply companies governed by the Electricity Supply Act, 1948;</li> <li>(d) Co-operative societies registered under the Co-operative Societies Act, 1912;</li> </ul>
---------------------------------	--

	<p>(e) Public and charitable trusts registered under various Religious and Endowment Acts;</p> <p>(f) Corporations set up under an Act of Parliament or State Legislature such as the LIC of India.</p> <p>(g) Specified entities under various sections of the Income-tax Act, 1961.</p>
<b>Voluntary Audits</b>	<ul style="list-style-type: none"> <li>◆ Audits of the accounts of proprietary entities, partnership firms, HUF, etc.</li> <li>◆ In respect of such entities, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit.</li> <li>◆ Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc.</li> <li>◆ But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit.</li> </ul>

### Important Questions

**Q. No. 6: Discuss the types of audits required under law.**

**[Nov. 11 (5 Marks)]**

#### 1.3 - Advantages of Audit of Financial Statements

<b>1. Protect the interest of fund providers</b>	It safeguards the financial interests of persons who are not associated with the management of the organisation e.g. partners or shareholders.
<b>2. Moral check on employees</b>	It acts as a moral check on employees from committing defalcations or embezzlement.
<b>3. Settlement of Taxes, etc.</b>	Auditing statements of accounts are helpful in settling of taxes, negotiating loans and for determining the purchase consideration for a business.
<b>4. Settlement of Trade Disputes</b>	Audited statements are useful for settling trade disputes for higher wages or bonus.
<b>5. Detection of Wastages</b>	Audited statements also help in detection of wastages and losses and shows the different ways by which these might be checked especially those that occurred due to absence or inadequacy of internal checks or internal control measures.
<b>6. Proper maintenance of books of account</b>	Independent 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.
<b>7. Appraisal of controls</b>	As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies etc.
<b>8. Admission/retirement of Partner</b>	Audited accounts are of great help in the settlement of accounts at the time of admission or death of the partner.
<b>9. Grant of License</b>	Government may require audited and certified statements before it gives assistance or issues the license for a particular trade.

### Important Questions

**Q. No. 7: What is the importance of having the accounts audited by independent professional auditors?**

**[May 01 (8 Marks)]**

Or

**What are the advantages of Independent audit?**

**[May 12 (8 Marks)]**

Or

**Discuss the following: Advantages of Independent Auditor.**

**[May 15 (5 Marks)]**

### 1.4 - 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, 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. The inherent limitations of an audit arise from:

<b>1. The Nature of Financial Reporting</b>	The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable FRF to the facts and circumstances of the entity. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.
<b>2. Nature of Audit Procedures</b>	There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example: <ul style="list-style-type: none"> <li>◆ Management &amp; others do not provide complete information intentionally/unintentionally.</li> <li>◆ Audit procedures used to gather audit evidence may be ineffective against fraud detection.</li> <li>◆ Audit is not an official investigation into alleged wrongdoings:</li> </ul>
<b>3. Timeliness of Financial Reporting &amp; the Balance between Benefit &amp; Cost</b>	<ul style="list-style-type: none"> <li>◆ User expectation that the auditor will form an opinion on the F.S. within a reasonable period of time and at a reasonable cost.</li> <li>◆ It results into use of Test checking and putting most of efforts over the areas having risk of material misstatement with corresponding less efforts in other areas.</li> </ul>
<b>4. Other Matters that affect the Limitations of an Audit</b>	In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include: <ol style="list-style-type: none"> <li>(a) Fraud, particularly fraud involving senior management or collusion.</li> <li>(b) The existence and completeness of related party relationships and transactions.</li> <li>(c) The occurrence of non-compliance with laws and regulations.</li> <li>(d) Future events or conditions that may cause an entity to cease to continue as a going concern.</li> </ol>

#### Important Questions

Q. No. 8: Discuss Limitations of audit.

[May 11 (8 Marks)]

Or

"The process of auditing is such that it suffers from certain limitations". Discuss.

Or

ABC Ltd. requested the auditor to provide for absolute assurance in respect of its ten branches scattered in Mumbai and confirm that financial statements are free from material misstatements due to fraud or error. Advise.

Q. No. 9: DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the financial year 2017-2018. 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.

<b>1.5 - Relationship of Auditing with other Disciplines</b>	
<b>Auditing and Accounting</b>	<ul style="list-style-type: none"> <li>◆ 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.</li> <li>◆ Auditing begins when accounting ends.</li> <li>◆ It requires that the auditor must have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.</li> </ul>
<b>Auditing and Law</b>	<ul style="list-style-type: none"> <li>◆ Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into as per the requirements of law, in particular, when an entity is governed by any law, for example companies.</li> <li>◆ It necessitates that an auditor should have a good knowledge of business and corporate laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc.</li> <li>◆ 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.</li> </ul>
<b>Auditing and Behavioural Science</b>	<p>The discipline of behavioural science is closely linked with the subject of auditing. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties, because of below mentioned aspects:</p> <ul style="list-style-type: none"> <li>◆ While performing audit, auditor is required to interact with a lot of people in the organisation.</li> <li>◆ Management auditor is expected to deal with human beings rather than financial figures.</li> <li>◆ One of the basic elements in designing the internal control system is personnel.</li> <li>◆ Internal control system in an organisation cannot work until and unless the people who are working in the organisation are competent and honest.</li> </ul>
<b>Auditing and Statistics &amp; Mathematics</b>	<ul style="list-style-type: none"> <li>◆ While performing audit, auditor examines the transaction on test checking basis, wherein auditor is required to select the samples.</li> <li>◆ Discipline of statistics plays an important role as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions.</li> <li>◆ The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.</li> </ul>
<b>Auditing and Data Processing</b>	<ul style="list-style-type: none"> <li>◆ Today, a number of 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.</li> <li>◆ To carry out audit in an computerised environment, the auditor should have good knowledge of the components, general capability of the system and the related terms.</li> <li>◆ In fact, EDP auditing in itself is developing as a discipline.</li> </ul>
<b>Auditing and Financial Management</b>	<ul style="list-style-type: none"> <li>◆ Auditing is closely related with functional fields of business such as finance, production, marketing, personnel and other general areas of business management.</li> <li>◆ The auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.</li> <li>◆ 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.</li> </ul>