CHAPTER 1
NATURE, OBJECTIVE AND SCOPE OF AUDIT

Highlights

1. Meaning, nature and scope of audit
2. Objectives of audit
3. Inherent Limitations of audit
4. Benefits of audit
5. Meaning of assurance engagements
6. Difference between reasonable assurance engagement and limited assurance engagement
7. Meaning and basic purpose of engagement and quality control standards
8. Practicality of above concepts by studying through examples and case studies

1. Introduction

Q. Users of Audited Financial Statements

1. Be it **investors** desirous of investing their money in companies, **shareholders** anxious to know financial position of companies they have invested.
2. **Banks or financial institutions** willing to lend funds to credit-worthy organizations.
3. **Governments** desirous of collecting taxes from trade and industry in accordance with applicable laws.
4. **Trade unions** negotiating with corporate managements for better wages.
5. **Insurance companies** wanting to settle property claims caused by fire or other disasters.

Table 4. 2017 Revenue and Expenses Summary (all funds)
(in thousands of CAD)

REVENUE:	
Contributions for project agreements	130 370
Assessed contributions	101 031
Other revenue-producing activities	22 479
Other voluntary contributions	13 281
Other revenue	5 275
Total revenue	**272 436**
EXPENSES:	
Staff salaries and employee benefits	174 316
Supplies, consumables and others	53 308
General operating expenses	17 911
Travel and meetings	16 908
Other expenses	8 742
Total expenses	**271 185**
OPERATING SURPLUS	**1 251**

2. ORIGIN OF AUDITING

Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in **Kautilya's Arthshastra** even in **4th century BC**. It talks about fixed accounting year, a process for closure of accounts and audit for the same. Concepts of periodical checking and verification existed even in those times. Even there are references in his monumental work to misstatements in financial statements due to abuse of power.

Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.

The word "audit" originates from Latin word **"audire"** meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent. Industrial revolution in Europe led to astronomical expansion in volume of trade and consequently demand of auditors.

The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

- Understand that preparation and presentation of financial statements of an entity is responsibility of management of entity.
- The auditor expresses an opinion on financial statements by means of written audit report.

In doing so, he has to see that financial statements would not mislead anybody by ensuring that:

1. The Accounts have been drawn up with reference to **entries** in the books of account;
2. The Entries in the books of account are adequately supported by sufficient and appropriate **evidence**;
3. None Of the entries in the books of account has been **omitted** in the process of compilation;
4. The Information conveyed by the statements is **clear and unambiguous**;
5. The Financial statement amounts are properly **classified, described and disclosed** in conformity with accounting standards; and
6. The Statement of accounts presents a **true and fair** picture of the operational results and of the assets and liabilities.

1. **Auditing and Accounting:** Auditing reviews the financial statements which are nothing but a result of the overall accounting process.
2. **Auditing and Law:** An auditor should have a good knowledge of business laws affecting the entity.
3. **Auditing and Economics:** Auditor is expected to be familiar with the overall economic environment of the client.
4. **Auditing and Behavioral Science:** Knowledge of human behavior is essential for an auditor to effectively discharge his duties.
5. **Auditing and Statistics & Mathematics:** Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.
6. **Auditing and Data Processing:** EDP auditing in itself is developing as a discipline in itself.
7. **Auditing and Financial Management :** Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.
8. **Auditing and Production:** Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

3. OBJECTIVES OF AUDIT

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -

1. To obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
2. To **report** on the financial statements, and **communicate** as required by the SAs, in accordance with the auditor's findings.

REASONABLE ASSURANCE V/S ABSOLUTE ASSURANCE

- Reasonable assurance is to be distinguished from absolute assurance.
- Absolute assurance is a complete assurance or a **guarantee** that financial statements are free from material misstatements.
- However, reasonable assurance is not a complete guarantee. Although it is a **high-level** of assurance but it is not complete assurance.

4. SCOPE OF AUDIT-WHAT IT INCLUDES

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

(1) Coverage of all aspects of entity

A. Audit of financial statements should be organized adequately to **cover all aspects** of the entity relevant to the financial statements being audited.

(2) Reliability and sufficiency of financial information

A. The auditor should be reasonably satisfied that **information** contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is **reliable and sufficient** basis for preparation of financial statements.

B. The auditor makes a judgment of reliability and sufficiency of financial information by making a **study and assessment of accounting systems and internal controls** and by carrying out appropriate tests, enquirers and procedures.

(3) Proper disclosure of financial information

A. The auditor should also decide whether relevant information is **properly disclosed** in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

B. It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the **judgments made by management** in preparation of financial statements.

C. The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. **For example**, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

D. The auditor evaluates **selection and consistent application of accounting policies** by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Q. What is Historical Financial Information?

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

For example, when purchases and sales are reflected in financial statements of an entity, these are examples of historical financial information. These are about transactions which have occurred in past.

Since financial statements are prepared on the basis of historical financial information, it is logical that audit of financial statements is also based upon such historical financial information. Therefore, audit of financial statements is based upon historical financial information.

4.1 Scope of Audit-What It Does Not Include

1) Auditor is **not expected** to perform duties which fall **outside domain** of his competence.

For example,

a. Physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.

b. An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

2) An audit is **not an official investigation** into alleged wrong doing. He does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

4.2 Difference Between Audit & Investigation

A) Audit is distinct from investigation. **Investigation is a critical examination** of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

B) The objective of audit, on the other hand, as has already been discussed, is to **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

C) The scope of audit is **general** and broad whereas scope of investigation is **specific and narrow**.

5. INHERENT LIMITATIONS OF AUDIT

Q. Why Auditor Cannot Provide Absolute Assurance?

The process of audit suffers from certain **inbuilt limitations** due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

(1) Nature of Financial Reporting

a. Preparation of financial statements involves making many **judgments by management**. These judgments may involve **subjective decisions** or a degree of **uncertainty**. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

b. One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such **controls** may not have operated to produce reliable financial information due to their **own limitations**.

For example, that management of a company has devised a control that all purchase bills should reflect stamp and signatures of an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises. It is an example of internal control devised by the company to ensure that only those purchase bills are produced for payment for which goods have been actually received. Now, what happens if concerned accountant and authorised person in "Goods Receiving Section" collude. It is a case of overriding of internal controls devised by the company due to collusion between two persons. Such a probable collusion is one of limitations of internal controls itself.

(2) Nature of Audit procedures

a. The auditor carries out his work by obtaining audit evidence through performance of audit procedures.

b. However, there are **practical and legal limitations** on ability of auditor to obtain audit evidence. **For example**, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

c. Management may **not provide complete information** as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

d. The management may consist of **dishonest and unscrupulous people** and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

e. Auditor is **not an expert in authentication of documents**. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

f. It is quite possible that entity may have entered into some **transactions with related parties**. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

(3) Not in nature of investigation
Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(4) Timeliness of financial reporting and decrease in relevance of information over time
The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.
For example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his third year stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.

(5) Future events
Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.
Conclusion : Therefore, it is in view of above factors, that an auditor cannot provide a guarantee that financial statements are free from material misstatements due to frauds or errors.

6. WHAT IS AN ENGAGEMENT?

Engagement means an arrangement to do something. In the context of auditing, it means a **formal agreement** between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

6.1 External Audit Engagements

The purpose of external audit engagements is to **enhance the degree of confidence** of intended users of financial statements. Such engagements are also reasonable assurance engagements. **For example**, in India, companies are required to get their annual accounts audited by an external auditor. Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.

7. BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?

1. Audited accounts provide **high quality information**. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
2. In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their **interest is safeguarded by an audit**.
3. An audit acts as a **moral check** on employees from committing frauds for the fear of being discovered by audit.
4. Audited financial statements are helpful to **government** authorities for determining tax liabilities.

5. Audited financial statements can be relied upon by **lenders, bankers** for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
6. An audit may also **detect fraud or error** or both.
7. An audit reviews existence and **operations of various controls** operating in any entity. Hence, it is useful at pointing out deficiencies.

8. AUDIT- MANDATORY OR VOLUNTARY?

1. It is not necessary that audit is always legally mandatory. There are entities like companies who are compulsorily required to get their accounts audited under law.
2. Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. For example, in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.
3. It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.
4. Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

9. WHO APPOINTS AN AUDITOR?

1. Generally, an auditor is appointed by **owners** or in some cases by **constitutional or government authorities** in accordance with applicable laws and regulations. **For example**, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.
2. However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India **(CAG)**, an independent constitutional authority. In case of a firm who engages an auditor to audit its accounts. In such a case, auditor is appointed by partners of firm. There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation.
   For example, an auditor may be appointed under tax laws by a government authority.

10. TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The outcome of an audit is written audit report in which auditor expresses an opinion. The report is submitted to **person making the appointment**. In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

NOTES