

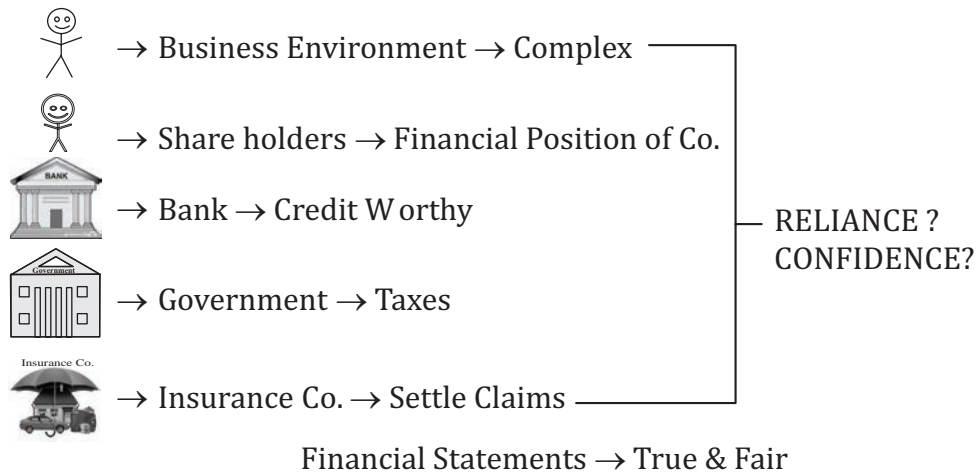
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CHAPTER

Nature, Objectives and Scope of Audit

■ INTRODUCTION

Business Environment → Complex



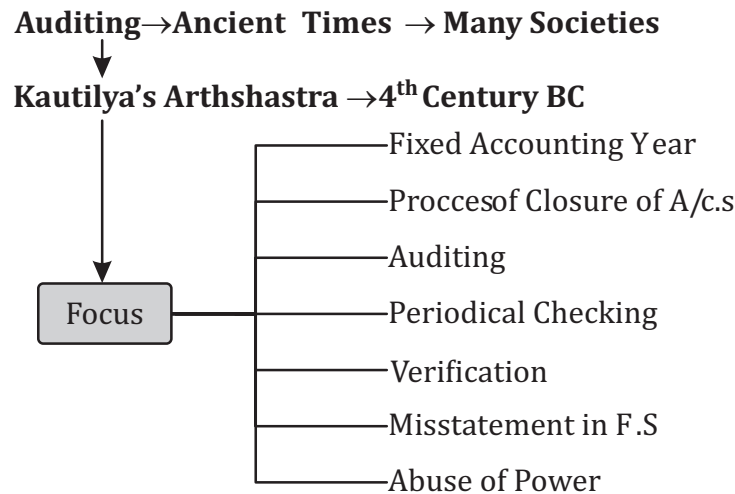
What do such real-life situations highlight? Such instances underline importance of auditing in today's complex business environment. Be it investors desirous of investing their money in companies, shareholders anxious to know financial position of companies they have invested in, banks or financial institutions willing to lend funds to credit-worthy organizations, governments desirous of collecting taxes from trade and industry in accordance with applicable laws, trade unions negotiating with corporate managements for better wages or insurance companies wanting to settle property claims caused by fire or other disasters- range of diverse users in equally diverse fields rely upon audited financial statements.

Can you figure out reason behind such reliance? It is due to the fact that audited financial statements provide confidence to users of financial statements; audited financial statements provide assurance to users who may take their decisions on the basis of such audited financial statements.

Herein lies the importance of auditing. You can very well understand how significant is role of auditing profession and auditors in modern world involving multitude of economic activities being carried out in equally dynamic legal and regulatory environments.

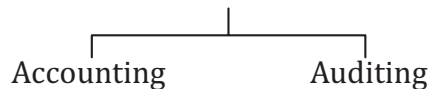
Here, comes a vital question. What do we mean by auditing? What is its nature and scope? What it includes and What it does not? What are its limitations? We shall try to find out answers to these questions in succeeding paras.

■ ORIGIN OF AUDITING



Origin of the word 'Audit' → Latin → Audire → To HEAR

I Auditor General of India → 1860



Presently → Constitutional Authority

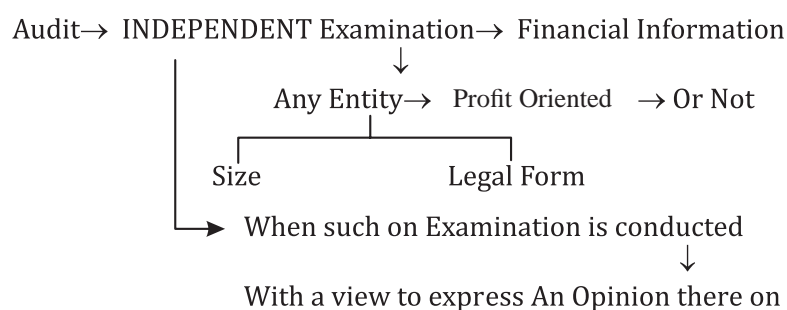
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C & AG

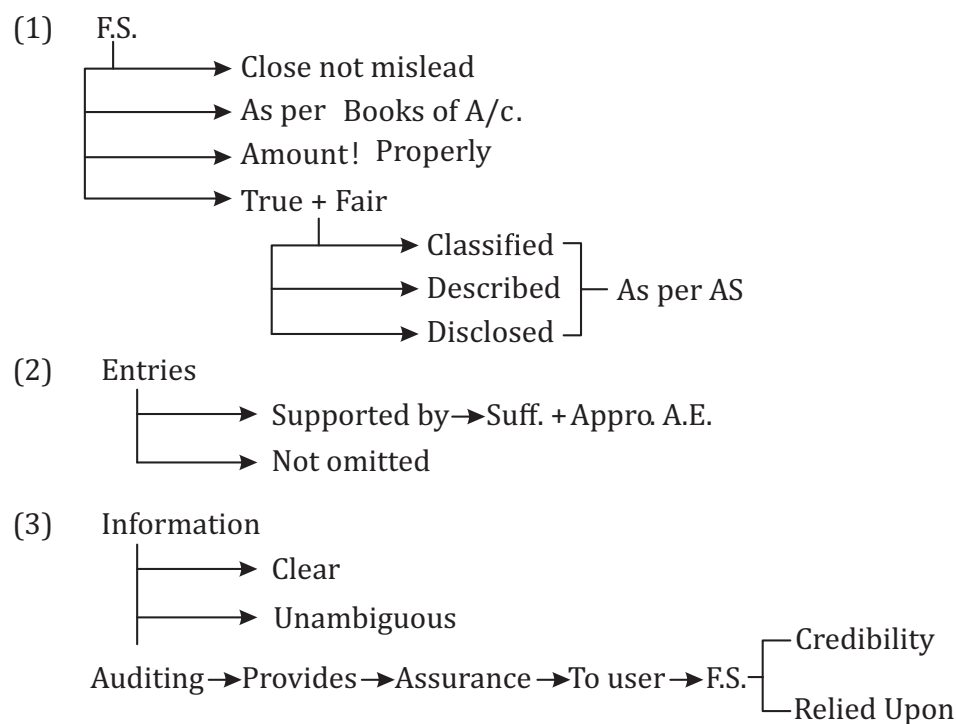
IACI → Statutory Body → Act of Parliament

Before we get to understand meaning and nature of auditing, let's travel back in time to know about 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. Wasn't he far ahead of his times? 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. 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 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.

■ MEANING AND NATURE OF AUDITING



Auditor to Ensure



“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”. An incisive analysis of above meaning of auditing brings out following points clearly:

Audit is an independent examination of financial information

Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence.

Independence increases auditor's ability to act objectively without creeping in of any biases.

Consider, for example, a person who requests his brother, a Chartered Accountant, to audit accounts of his proprietary concern and issue a report.

Can CA audit accounts of concern in which his brother is sole proprietor? No, he cannot. It is due to the fact that there would be no independence in such a case due to relationship by birth between CA and his brother. He would be subject to influence from his brother.

Take another case where a CA has invested in shares of a company. Can he audit accounts of such a company in which he holds shares? The answer is resounding NO. It is due to the fact that by holding shares of the company, his own self-interest gets involved. His own money is invested in the company and he may not be able to form judgment independently on the financial statements of the company.

- ❑ The entity whose financial information is examined need not necessarily be profit oriented like in case of a business. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a small, medium or large. Further, it can be conducted for any entity irrespective of its legal structure i.e. such an entity may be a proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.
- ❑ The purpose of audit is to express an opinion on the financial statements.

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:
 - The accounts have been drawn up with reference to entries in the books of account;
 - The entries in the books of account are adequately supported by sufficient and appropriate evidence;
 - None of the entries in the books of account has been omitted in the process of compilation;
 - The information conveyed by the statements is clear and unambiguous;
 - The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
 - The statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Auditing provides assurance. Its basic nature lies in providing assurance to users - providing confidence to users of financial statements. Such an assurance lends credibility to financial statements. Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.

QUESTIONS

Theory Questions

1. Explain clearly meaning of Auditing. How would you as an auditor perform the audit.

Ans. “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.”

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:

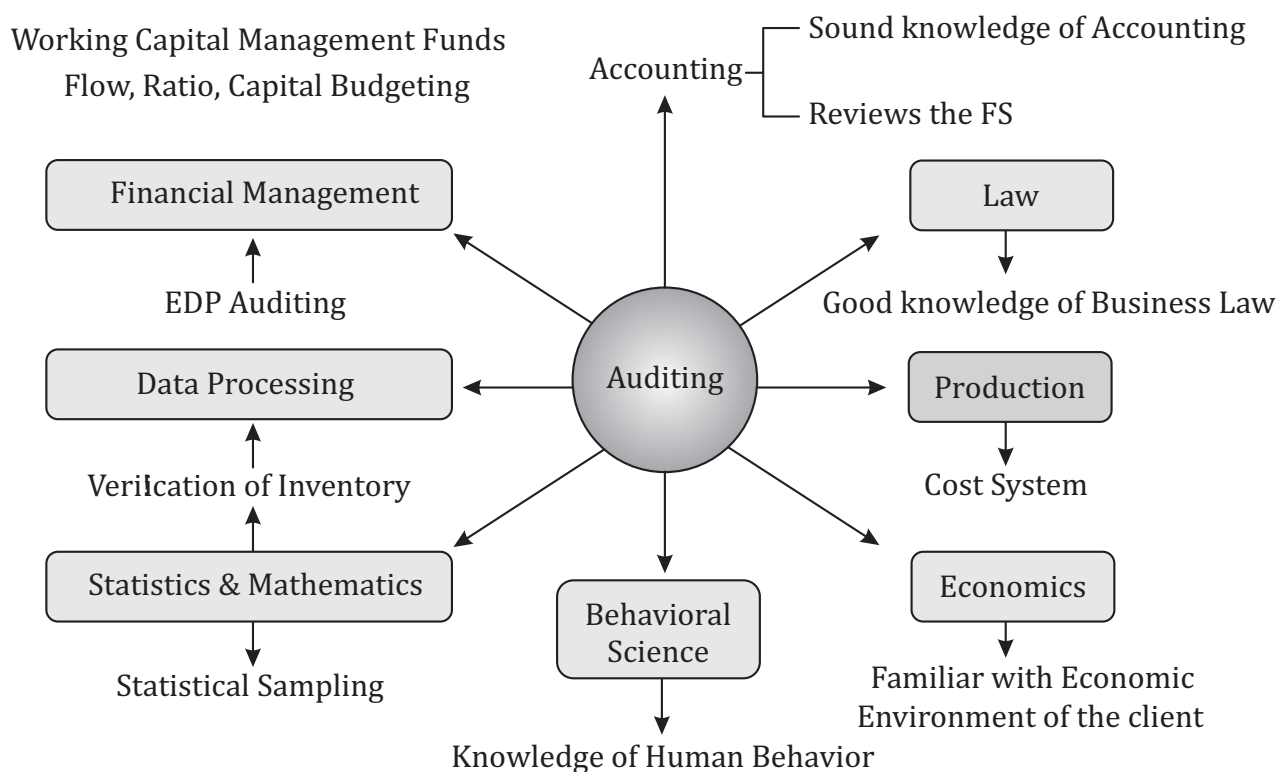
- (i) The accounts have been drawn up with reference to entries in the books of account;
- (ii) The entries in the books of account are adequately supported by sufficient and appropriate evidence;

- (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.

Notes to Add

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■ INTERDISCIPLINARY NATURE OF AUDITING-RELATIONSHIP WITH DIVERSE SUBJECTS



Auditing is interdisciplinary in nature. It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects. Since audit of financial statements is concerned with financial information, a sound knowledge of accounting principles is a fundamental requirement for an auditor of financial statements to conduct audit and express an opinion. Similarly, good knowledge of business laws and various taxation laws helps auditor to understand financial statements in a better way in accordance with applicable laws.

During course of audit, auditor has to interact with lot of persons for seeking information and making inquiries. This can be done only if one has knowledge of human behaviour. Auditors use statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction. So, use of statistical methods to draw samples for conducting audit is made.

Knowledge of subject like economics helps auditor to be familiar with overall economic environment in which specific business is operating. Financial management deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to be knowledgeable about these for applying some of audit procedures and carrying out audit effectively. Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.

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: 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.

QUESTIONS

Correct/Incorrect

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

- According to Mr. H, one of the team members of the auditor of Very Essential Limited was of the view that no relation exists between accounting and auditing from the point of view of a company.

Ans. Incorrect: The viewpoint of Mr. H is incorrect because there exists a proper relation between accounting and auditing from the point of view of a company. Audit is conducted for financial statements of a company and those financial statements are prepared with the help of books of accounts of that company. In order to properly conduct an audit of a company, an auditor is required to be aware of accounting principles and accounting policies of that company.

3. Mr. S, one of the new team members of the auditor of Extremely Effective Limited was of the view that for the purpose of conducting an audit, only knowledge of direct tax is required whereas no knowledge of indirect tax is required.

Ans. Incorrect: The viewpoint of Mr. S is incorrect because for the purpose of conducting an audit, proper knowledge of both direct tax as well as indirect tax is required.

Theory Questions

4. “The independent audit of an entity’s financial statements is a vital service to investors, trade payables, and other participants in economic exchange”. Explain

Ans. 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 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 of whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. 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 organization 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 payable, and other participants in economic exchange.

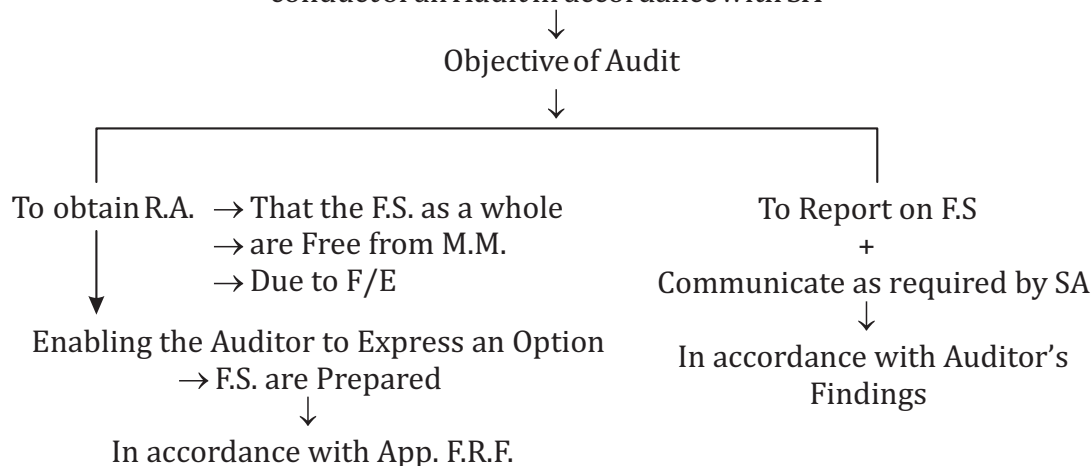
5. Mr. G, one of the team members of audit team of Different and Capable Limited was of the view that role of computers and data processing in auditing is increasing with each passing day. Explain how computers and data processing helps in conducting audit of a company.

Ans. The role of computers and data processing is important while conducting the audit of a particular company. Computers are able to save and process large volumes of data and at the same time provide that data whenever required. This way computers and data processing would be of huge help to the auditor in terms of saving time and efforts while conducting the audit of a company.

Notes to Add

■ OBJECTIVES OF AUDIT

As per SA 200 → Overall OBJECTIVES of an Independent Auditor of the conduct of an Audit in accordance with SA



Absolute Assurance = Guarantee

R.A. ≠ Not Guarantee

= High Level of Assurance

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

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

An analysis of above brings out following points clearly:

- (i) Auditor’s objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error. Reasonable assurance is 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.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.

- (ii) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.

- (iii) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables 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.
- (iv) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing. (You would be studying about these in subsequent parts of this Chapter).

QUESTIONS

Theory Questions

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

6. The basic objective of audit does not change with reference to nature, size or form of an entity.

Ans. (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.

7. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

Ans. (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.

8. State the objectives of Audit according to SA 200 (ICAI Study Material)

Ans. 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, 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
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings.

9. CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? (May 2022)

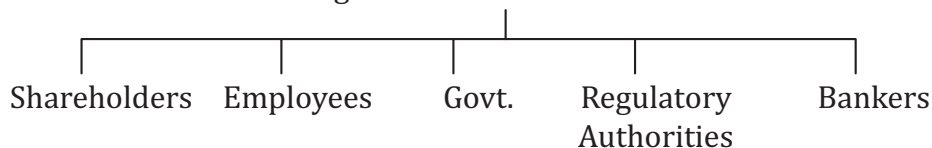
Ans. Overall Objectives of the Independent Auditor: As per SA-200 “Overall Objectives of the Independent Auditor”, in conducting an audit of financial statements, the overall objectives of the auditor are:

- In the given case of SR Ltd, CA N expressed his opinion on the financial statements of SR Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that CA N did not comply with the objective of audit as stated in SA 200.

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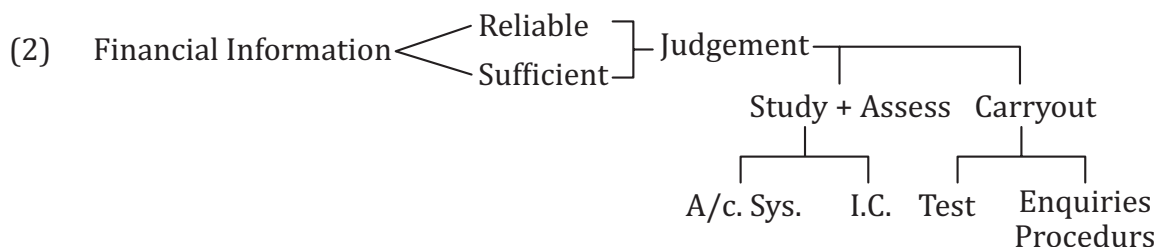
■ SCOPE OF AUDIT-WHAT IS INCLUDED

- Scope = Range or Reach
- Purpose of Audit = Enhance the degree of Confidence of the intended user of FS.

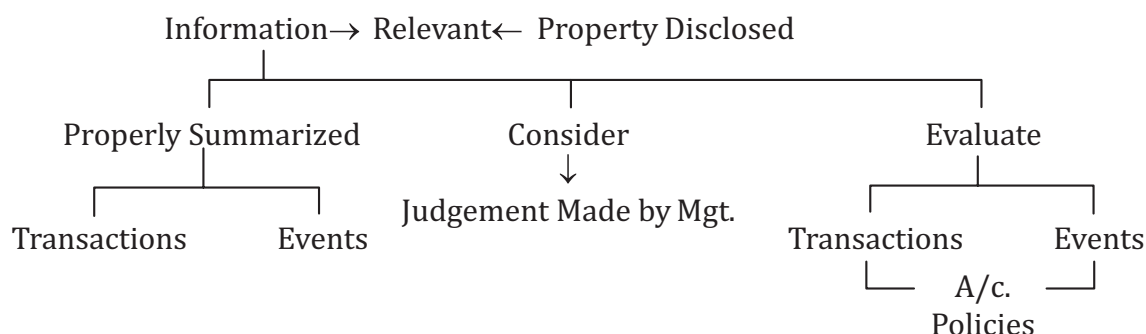


- Scope of Audit

(1) Cover adequately all ASPECTS of an enterprise

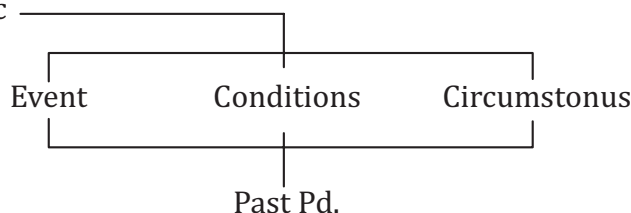


(3)



(4) Historical Financial Info.

- Financial Terms
- Relation to particular entity
- Derived from A/c. Sys.
- About Economic



Scope refers to range or reach of something. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. Users of financial statements may be shareholders, employees, customers, government and regulatory authorities, bankers etc. Enhancing of degree of confidence 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.

(Applicable financial reporting framework means a framework adopted in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.)

For example, in case of companies in India, financial reporting framework is provided under Schedule III of Companies Act, 2013.

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

- (1) Coverage of all aspects of entity Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited.
- (2) Reliability and sufficiency of financial information The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements.

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

- (3) Proper disclosure of financial information

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.

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

The 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.

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.

Understand that financial statements of an entity are prepared on historical financial information basis. "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.

■ SCOPE OF AUDIT-WHAT IS NOT INCLUDED

Auditor is NOT EXPECTED to:

(1) Perform duties



which fall outside the domain of his competence

(2) Determine suitability + Life of civil structures (Bldg.)

(3) Authenticate Documentation Not on Expert

(4) Audit Not official investigation Alleged wrongdoing

(5) Auditor specific legal power

(6) Audit ≠ Investigation



Obtain R.A.

└──────────Critical Examination of A/c.

└──────────With a special purpose

F.S. as a whole are free from MM Due to F/E

(7) Responsibility → Preparation FS

Auditor is not expected to perform duties which fall outside domain of his competence. For example, 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.

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.

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.

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.

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.

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

Test Your Understanding

1. Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

Ans. An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

2. Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean.

During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

Ans. Proper disclosure of financial information is well within scope of audit.

3. A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

Ans. Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

Notes to Add

■ INHERENT LIMITATIONS OF AUDIT

Auditor

- NOT EXPECTED to Reduce the Audit Risk to ZERO
- CANNOT obtain ABSOLUTE ASSURANCE

↓
That the FS. as a whole
↓
are FREE from MM
↓
Due to FE

Factor

- (1) Nature of Financial Reporting
Preparation of FS → Involves → Mgt. Judgement
- (2) Nature of Audit Procedures
Practical + Legal Limitations
↓
Sampling Approach
Mg +

Intentionally

Unintentionally

 → May not provide complete info

Sophisticated

Carefully Organised

 → Scheme
→ Fraud may involve
↓
Fabricated Documents
→ Related party transactions
- (3) Not in Nature of Investigation
Not official Investigation
- (4) Timeliness of Financial Reporting & Decrease in Relevance of Info. Over Time Balance b/w.
Reliability of Info \cong cost of obtaining it
- (5) Future Events
Entity' ability to continue as Going Concern

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

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.

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.

Consider, 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

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. 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.

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.

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.

We have already discussed under section on scope of audit that an 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.

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

As already discussed, 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. Consider, 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.

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.

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.

Not in the nature of Investigation: An audit is not an official investigation into alleged wrongdoing.

Timeliness of financial reporting and decrease in relevance of information over time: Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

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

QUESTIONS

Multiple Choice Questions (MCQ)

1. Which of the following is not an advantage of audit?
 - (a) It provides high quality
 - (b) It acts as a moral check on employees
 - (c) It enhances risk of management bias
 - (d) It helps in safeguarding interests of shareholders

Ans. (c) It enhances risk of management bias

Theory Questions

10. An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

Ans. Nature of Audit procedures

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. 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.

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

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.

We have already discussed under section on scope of audit that an 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.

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.

- 11.** 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.

Ans. 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.

- 12.** DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2019 - 2020. 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.

Ans. 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.

- 13.** In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

Ans. 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:

- 14.** An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss

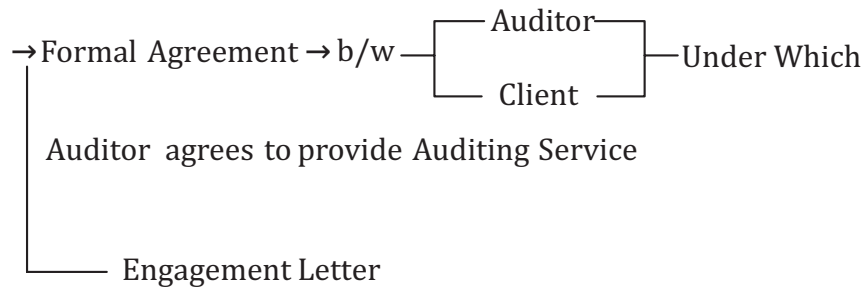
The objective of audit, on the other hand as we have already discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

[illegible]

■ WHAT IS AN ENGAGEMENT?

Arrangement to do something



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.

Notes to Add

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■ EXTERNAL AUDIT ENGAGEMENT / REASONABLE ASSURANCE ENGAGEMENT

Purpose → Enhance the degree of confidence



of the intended use of F.S.

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.

Notes to Add

[illegible]

■ BENEFITS OF AUDIT / WHY IS AUDIT NEEDED?

(1) Audited A/c. → provide → High Quality Info.



Give confidence to user of FS

(2) Interest of shareholders → safeguarded

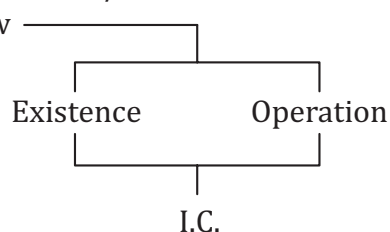
(3) Moral Check on employees

(4) Helpful for Govt. → determine Tax Liabilities

(5) Relied upon by Bankers / Lenders

(6) Detection of F/E

(7) Review



Benefits of Audit-why Audit is Needed?

- ❑ 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.
- ❑ 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.
- ❑ An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- ❑ Audited financial statements are helpful to government authorities for determining tax liabilities.
- ❑ 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.
- ❑ An audit may also detect fraud or error or both.
- ❑ An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

Notes to Add

■ AUDIT-MANDATORY OR VOLUNTARY?

Mandatory

→ Companies

→ Entities



T/o > threshold limit as per Income Tax

→ Organization → Receiving Govt. Grants

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. 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.

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.

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.

Notes to Add

[illegible]

■ WHO APPOINTS AN AUDITOR?

Generally	→	Owners
Constitutional/Govt. Authorities	→	As per Law/Regulation
Companies (Non-Govt.)	→	Members (Shareholders) @ AGM
Companies (Govt.)	→	C & AG
Firms	→	Partners

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.

However, in case of government companies in India, auditor is appointed by Comptroller & Auditor General of India (CAG), an independent constitutional authority. Take 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.

Notes to Add

[illegible]

■ TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

Report → Written

Submitted → To the person Making Appointment

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

We shall now discuss understanding reached so far from a case study involving discussion among students regarding nature, scope, limitations, benefits of auditing and other related matters.

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai.

They have cleared CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of them are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been able to join Live Coaching Classes yet as she was away on a holiday with her parents. However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers. Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every transaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of the companies. Not to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something of his own.

QUESTIONS

Multiple Choice Questions (MCQ)

2. Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?
- (a) It provides reasonable assurance meaning a moderate level of assurance.
 - (b) It provides reasonable assurance meaning a low level of assurance
 - (c) It provides reasonable assurance meaning a high level of assurance
 - (d) It provides reasonable assurance meaning an absolute level of assurance

Ans. (c) It provides reasonable assurance meaning a high level of assurance

3. Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?

- (a) Yes, he can do so. It is necessary to obtain audit evidence
- (b) Yes, he can do so. There are express rights given to him in this respect
- (c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him
- (d) No, he cannot do so. He has no right of seeking information and documents. Therefore, question of forcing does not arise

Ans. (c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him

4. Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?

- (a) Only view of Ali is correct
- (b) Only view of Goreti is correct
- (c) Views of both Ali and Goreti are correct
- (d) Views of both Ali and Goreti are incorrect

Ans. (d) Views of both Ali and Goreti are incorrect

5. All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?

- (a) Since auditing is connected to future events, audited information can be easily relied upon by users
- (b) Errors or frauds may be discovered during audit
- (c) Government authorities can make use of audited accounts for different purposes
- (d) It can help in bringing out deficiencies in maintenance of financial records

Ans. (a) Since auditing is connected to future events, audited information can be easily relied upon by users

6. Goreti told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of following statements seems to be appropriate in this regard?

- (a) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.
- (b) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.
- (c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

(d) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.

Ans. (c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

Test Your Understanding

4. Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.

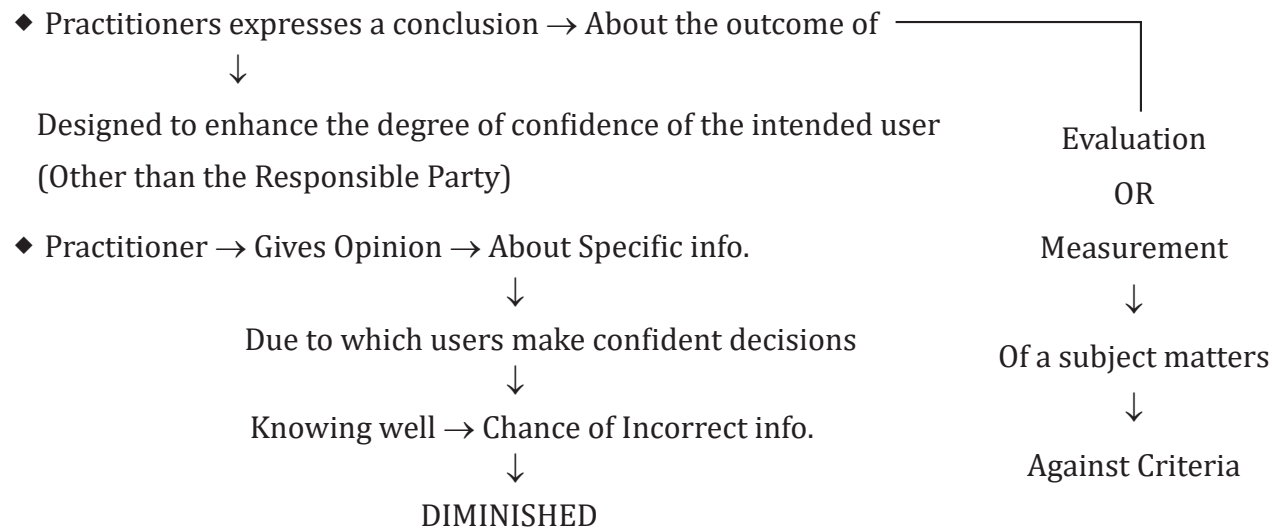
However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.

The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation. Audit is a type of assurance engagement under which auditor gives an opinion as to whether financial statements give a true and fair view of state of affairs of the concern. However, assurance engagements are not restricted to audit alone. We shall now discuss meaning of assurance engagement and different types of assurance engagements.

Ans. It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

Notes to Add

■ MEANING OF ASSURANCE ENGAGEMENT

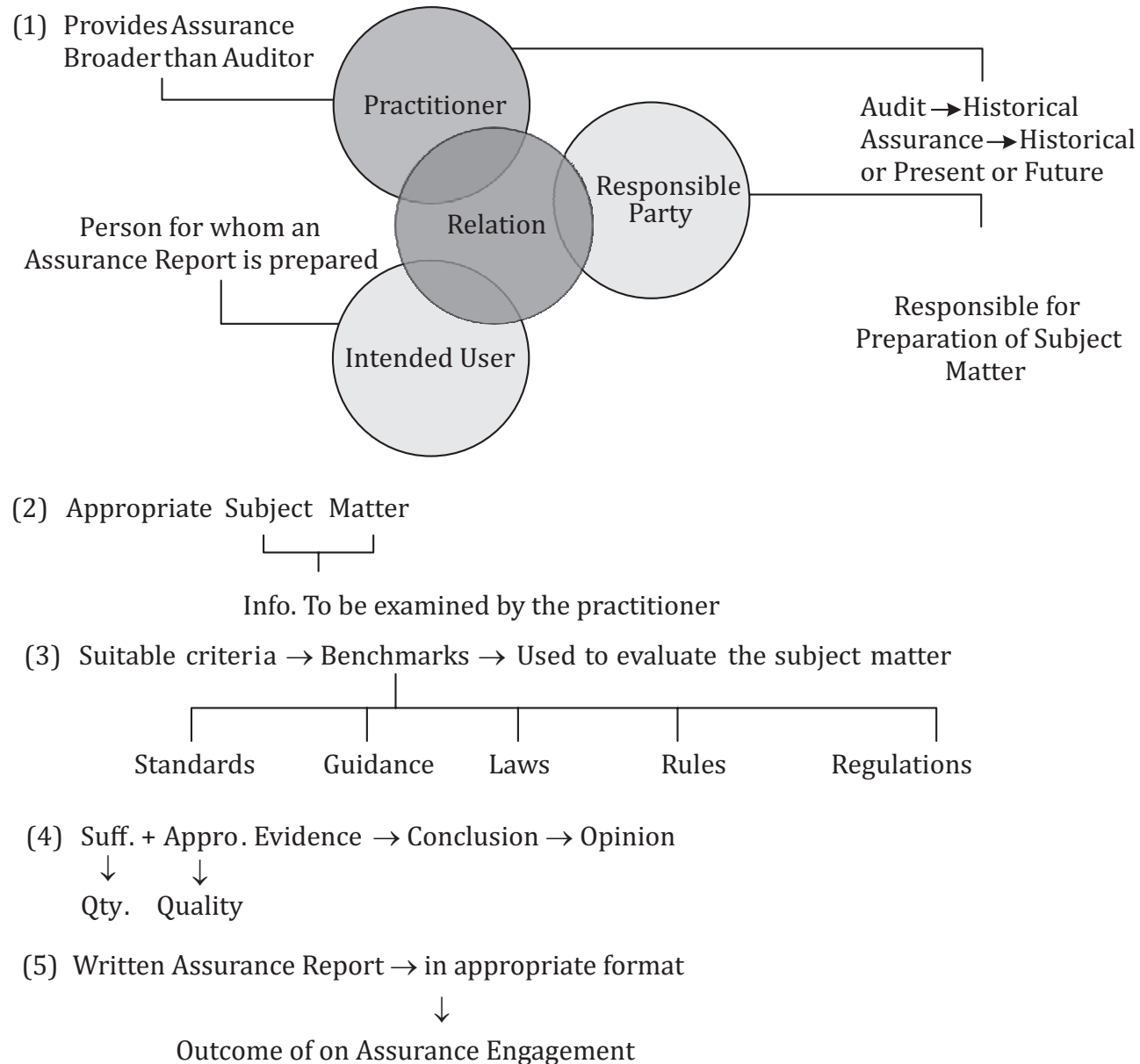


“Assurance engagement” means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

Notes to Add

[illegible]

■ ELEMENTS OF AN ASSURANCE ENGAGEMENT



Following elements comprise an assurance engagement:

- (1) A three party relationship involving a practitioner, a responsible party, and intended users
An assurance engagement involves abovesaid three parties. A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
A responsible party is the party responsible for preparation of subject matter. Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.
- (2) An appropriate subject matter It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

- (3) **Suitable criteria** These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.
- (4) **Sufficient appropriate evidence** The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.
“Sufficient” relates to quantity of evidence obtained by auditor. “Appropriate” relates to quality of evidence obtained by auditor. One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.
- (5) **A written assurance report in appropriate form**
A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

QUESTIONS

Multiple Choice Questions (MCQ)

7. Which of the following is NOT TRUE about an assurance engagement?

- (a) It relates to providing assurance about historical financial information only
- (b) The practitioner obtains sufficient appropriate evidence
- (c) There is some information to be examined by practitioner
- (d) A written assurance report in appropriate form is issued by practitioner

Ans. (a) It relates to providing assurance about historical financial information only

Notes to Add

■ AUDIT VS. REVIEW

Audit	vs.	Review
→ R.A. Engagement		→ Limited Assurance Engagement
→ Higher assurance		→ Lower level of assurance
→ More Procedures		→ Fewer Procedures
→ Scope of Conclusion is higher		→ Limited Conclusion
→ Both are related to FS prepared on the basis of HISTORICAL FINANCIAL INFO.		

We have learnt that audit is a reasonable assurance engagement. It provides reasonable assurance. However, review is a limited assurance engagement. It provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up. However, both “audit” and “review” are related to financial statements prepared on the basis of historical financial information.

■ R.A. ENGAGEMENT VS. L.A. ENGAGEMENT

Basis	R.A.E	L.A.E.
Level	Higher	Lower
Audit Procedure	Elaborate & Extensive	Fewer Procedure as compared with RA
Conclusion	Reasonable	Limited
Example	Audit Engagement	Review Engagement

Types of Assurance Engagements Reasonable assurance engagement vs. Limited assurance engagement

As already discussed, assurance engagements provide assurance to users. The difference is of degree. Reasonable assurance engagement like audit provides reasonable assurance which is a high level of assurance. Limited assurance engagement like review provides lower level of assurance than audit. It is only a moderate level of assurance.

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

QUESTIONS

Correct/Incorrect

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

- 15.** A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement.

Ans. It is not a reasonable assurance engagement. It is in nature of investigation.

Correct/Incorrect

- 16.** 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.

Ans. (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.

Multiple Choice Questions (MCQ)

- 8.** Consider following statements in relation to "Limited assurance engagement":-

Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.

Statement II - Review of interim financial information of a company is an example of limited assurance engagement.

- (a) Statement I is correct. Statement II is incorrect
- (b) Both Statements I and II are correct
- (c) Both Statements I and II are incorrect
- (d) Statement I is incorrect. Statement II is correct

Ans. (d) Statement I is incorrect. Statement II is correct

Notes to Add

■ AUDIT & REVIEW VS. PROSPECTIVE FINANCIAL INFO

Audit & Review → Historical Financial info.

Prospective Financial Info. → NOT Historical Financial Info.

- └ Generally on I.C. of an entity
- └ Based on Assumptions → About events



That may occur in the future



Possible Actions by an Entity

- └ In the form of
 - Forecast
 - Projection

- └ Obtains Suff. + Appro. A.E. → about Mgt.'s Assumptions



NOT UNREASONABLE

- └ Financial Info. → Properly
 - Prepared
 - Presented
 - Disclosed

- └ Moderate level of Assurance

- └ Auditor → NOT in a position → to express an opinion



Results shown Will be achieved

- └ Report :- Nothing has come to practitioner's attention



To suggest that these assumptions

Do not Provide a reasonable basis for the projection

Besides reasonable assurance engagements and limited assurance engagements, there is another kind of assurance which is related to matters other than historical financial information. Such an assurance may relate to prospective financial information and not to historical financial information. It may relate to providing assurance on internal controls in an entity.

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

It is to be noted that in such type of assurance engagements, examination is not of historical financial information.

Here, it is important to note the difference between “Historical financial information” and “Prospective financial information.” The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events. In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management’s assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

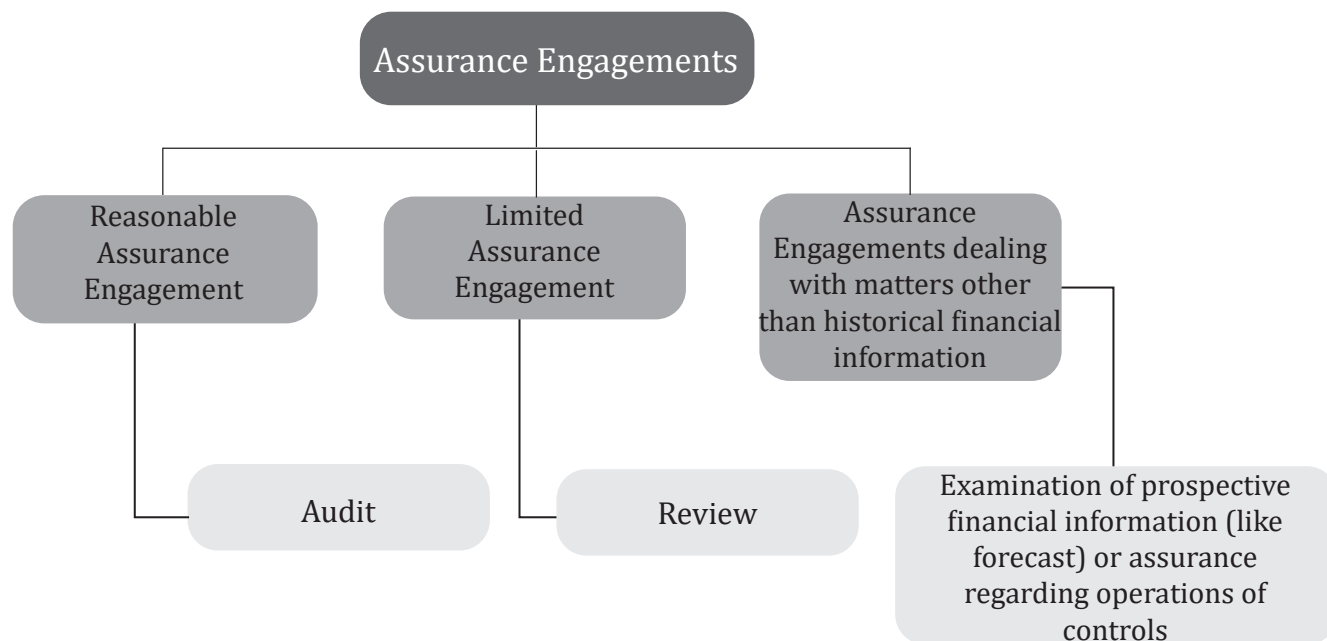
Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner’s attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a “moderate” level of assurance.

■ EXAMPLES OF ASSURANCE ENGAGEMENTS

Checkbox	Example of engagement Assurance	Type of assurance engagement
✓	Audit of statements financial	Reasonable assurance engagement
✓	Review of statements Financial	Limited assurance engagement
✓	Examination of Prospective financial information	Provides
✓	Report on controls operating at an organization	Provides assurance regarding design and operation of controls



QUESTIONS

Theory Questions

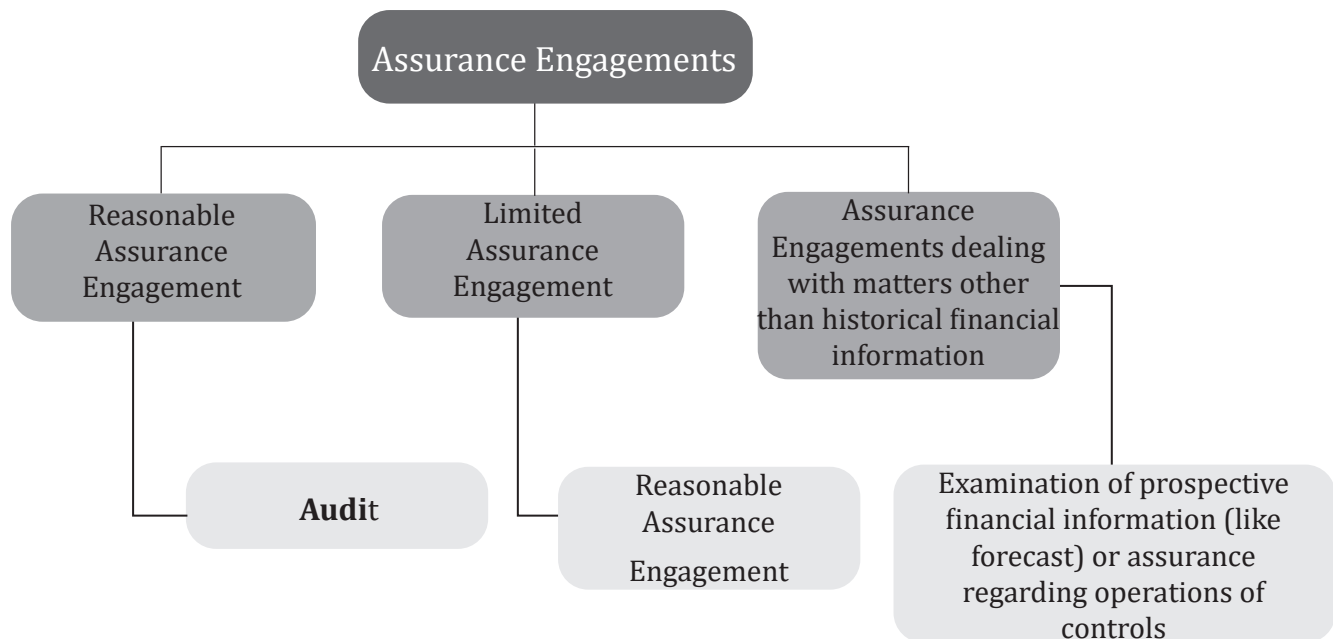
17. Assurance engagements are not restricted to audit of financial statements alone. Discuss.

Ans. Example of engagement Assurance

1. Audit of statements financial
2. Review of statements Financial
3. Examination of Prospective financial information
4. Report on controls operating at an organization

18. An assurance engagement involves a three party relationship. Discuss meaning of three parties in such an engagement.

Ans.



Test Your Understanding

5. The management of Exotic Tours and Travels Limited requests its auditor Raja & Co. to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures.

Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

Ans. Such report would be in nature of “review”. However, auditors would have to obtain sufficient appropriate evidence.

■ QUALITIES OF AN AUDITOR

- ❑ Tact, Caution, Firmness, Good Temper, Integrity, Discretion, Industry Judgement, Patience, Clear Headedness & Reliability
- ❑ Qualities of Good Businessman = Qualities of an Auditor
- ❑ Shine of culture for attaining great height
- ❑ Highest Degree of Integrity + Independence
- ❑ Basic Human Qualities
- ❑ Exhaustive Knowledge of Accounting is sine qua non
- ❑ Thoroughly known A/c. & Principles Techniques

An auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.

Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.

In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.

The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

QUESTIONS

Theory Questions

- 19.** Professional integrity and independence are considered essential characteristics of all the professions. There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance. Explain.

Ans. 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:

- (i) **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
- (ii) **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 so exist to all reasonable persons.

20. 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. Explain the guiding principles in the above context. (May 2023)

Ans. 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 principle 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, objective 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.

Notes to Add

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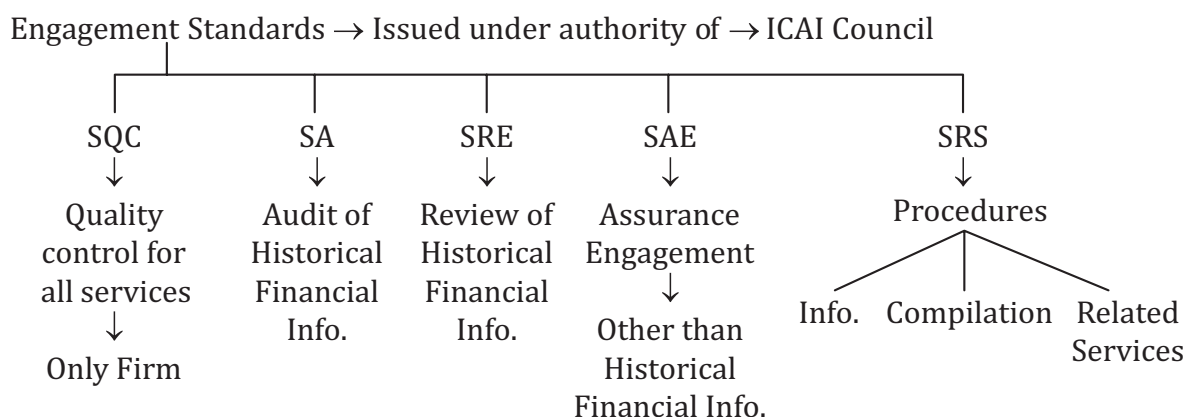
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■ ENGAGEMENT AND QUALITY CONTROL STANDARDS



□ Why are standards needed?

- (1) Carrying Audit as per Global Practices & Benchmarks
 - (2) Improve → Quality of F.R
 - (3) Promote → Uniformity
 - (4) Equips → Professional
 - (5) Ensure → Audit Quality
- Knowledge
- Skills

The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards:

- (1) Standards on auditing (SAs) which apply in audit of historical financial information.
- (2) Standards on review engagements (SREs) which apply in review of historical financial information.
- (3) Standards on Assurance engagements (SAEs) which apply in assurance engagements other than audits and review of historical financial information.
- (4) Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements.

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of financial statement audits and in other types of assurance services.

Notes to Add

■ STANDARDS ON AUDITING

Standards on Auditing apply in the context of an audit of financial statements by an independent auditor. It is important to remember that Standards on Auditing apply in audit of historical information. These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on financial statements. These cover all significant aspects of audit of financial statements.

Some examples of Standards on Auditing are:

- ❑ SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
- ❑ SA 230 Audit Documentation
- ❑ SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- ❑ SA 500 Audit Evidence
- ❑ Revised SA 700 Forming an Opinion and Reporting on Financial Statements

QUESTIONS

Multiple Choice Questions (MCQ)

9. Which of the following is TRUE about Standards on auditing?

- (a) These deal mainly with voluntary responsibilities of auditors
- (b) These deal mainly with mandatory responsibilities of auditors
- (c) Their sole purpose is to help government authorities in augmenting revenues
- (d) These deal mainly in carrying out audit according to legal provisions

Ans. (b) These deal mainly with mandatory responsibilities of auditors

Notes to Add

■ STANDARDS ON REVIEW ENGAGEMENTS

Standards on review engagements apply in the context of review of financial statements. We have already understood that review is a limited assurance engagement and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit. Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. For example, when an auditor performs review of interim financial information of an entity.

Examples of Standards on Review engagements are:

- ❑ SRE 2400 (Revised) Engagements to Review Historical Financial Statements
- ❑ SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

Notes to Add

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■ STANDARDS ON ASSURANCE ENGAGEMENTS

It is to be noted that both Standards on auditing and Standards on review engagements apply to engagements involving historical financial information.

There is another set of standards which apply in assurance engagements dealing with subject matters other than historical financial information. Such assurance engagements do not include “audit” or “review” of historical financial information. These standards are known as Standards on Assurance Engagements. For example, an assurance engagement relating to examination of prospective financial information.

It is to be noted that in such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

Examples of Standards on Assurance Engagements are:

- ❑ SAE 3400 The Examination of Prospective Financial Information
- ❑ SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Lastly, there are standards on related services. These standards apply in engagements to perform agreed-upon procedures regarding financial information. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.

An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

These types of services are called related services and standards have been issued to deal with practitioner’s responsibilities in this regard.

Examples of Standards on related services are:

- ❑ SRS 4400 Engagements to perform agreed-upon procedures regarding financial information
- ❑ SRS 4410 (Revised) Compilation engagements

It is to be clearly understood that all the above standards i.e., Standards on Auditing (SAs), Standards on Review Engagements (SREs), Standards on Assurance Engagements (SAEs) and Standards on related services (SRSs) are collectively known as the Engagement Standards.

Engagement Standards issued under the authority of Council of ICAI deal with responsibilities of auditor/practitioner.

Notes to Add

■ STANDARDS ON QUALITY CONTROL

Standards on Quality Control (SQC)s have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.

SQC 1 has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate.

Its basic objective is that while rendering services, to which engagement standards apply, there should be a system of quality control within firms to ensure compliance with professional standards/legal requirements. System of quality control ensures issuing of appropriate reports in the circumstances. Further, it is also to be remembered that Standards on Quality Control (SQCs) are to be applied for all services covered by Engagement Standards.

Notes to Add

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■ WHY ARE STANDARDS NEEDED?

- ❑ Standards ensure carrying out of audit against established benchmarks at par with global practices.
- ❑ Standards improve quality of financial reporting thereby helping users to make diligent decisions.
- ❑ Standards promote uniformity as audit of financial statements is carried out following these Standards.
- ❑ Standards equip professional accountants with professional knowledge and skill.
- ❑ Standards ensure audit quality.

Notes to Add

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■ DUTIES IN RELATION TO ENGAGEMENT AND QUALITY CONTROL STANDARDS

It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

QUESTIONS

Theory Questions

- 21.** 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 the importance to audit quality. Explain w.r.t. SA 220

Ans. As per SA 220 “Quality Control for an Audit of Financial Statement”, 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:

- (1) 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;
- (2) The fact that quality is essential in performing audit engagements.

Multiple Choice Questions (MCQ)

10. Which of the following is TRUE about Engagement Standards?

- (a) Engagement standards ensure proper rights to practitioners in course of performance of their duties
- (b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner
- (c) Engagement standards ensure uniformity by practitioners in course of performance of their duties
- (d) Engagement standards ensure savings in resources of clients

Ans. (c) Engagement standards ensure uniformity by practitioners in course of performance of their duties

Correct/Incorrect

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

22. The term “Engagement Standards” refer to Standards on Auditing only. (Imp. ICAI Study Material)

Ans. Incorrect: Engagement Standards refer not only to Standards on auditing but also to Standards on review engagements, Standards on assurance engagements and Standards on related services.

23. Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity. (November 2022)

Ans. Incorrect: Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates to prospective financial information.

Theory Questions

24. “Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management”. Do you agree? Discuss duty of auditor, if any, in relation to accounting policies.

Ans. Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management- Refer to scope of audit- what it includes.

Test Your Understanding

6. CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing. Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

Ans. He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

CASE STUDY

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery. Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc. However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

Assume, in above case, the company only provides trial balance, financial statements in draft/preliminary form along with accompanying records for the relevant half year to CA P and requests him to provide duly signed financial statements with a report for mutually agreed professional fees.

QUESTIONS

Theory Questions

Based on above, answer the following questions

25. The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?

- (a) Standards on Review Engagements
- (b) Standards on Auditing
- (c) Standards on Related Services
- (d) There are no standards for issuing report in such situation

Ans. (c) Standards on Related Services

26. Which of the following statements is MOST APPROPRIATE in given case situation?

- (a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work
- (b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.
- (c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.
- (d) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report.

Ans. (c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

27. In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the MOST APPROPRIATE statement: -

- (a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.
- (b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.
- (c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.
- (d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.

Ans. (c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.

28. The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?

- (a) Standards on Review Engagements
- (b) There are no standards for issuing such type of reports.
- (c) Standards on Related Services
- (d) Standards on Assurance Engagements

Ans. (d) Standards on Assurance Engagements

29. Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹100 crore for the next year, 150 crore & 200 crore for following years respectively as compared to present turnover of 25 crore in current half year. Identify the MOST APPROPRIATE statement in this situation:

- (a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.
- (b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.
- (c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.
- (d) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

