

# Nature of Auditing

Chapter 1 IPCC Paper 6: Auditing  
and Assurance

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## Learning Objectives

- Define Audit and understand Audit Objectives
- Know Role of International Auditing and Assurance Standards Board (IAASB)
- Role played by Auditing and Assurance Standards Board , ICAI
- Basic Principles of Audit
- Advantages and Limitations of Auditing
- Relationship of Audit with Other Disciplines
- Distinguish Between Auditing & Investigation
- Types of Audit

# Introduction

## Nature of Auditing



## Origin

- **Term Auditor**
  - Based on Latin word audire
    - 'to hear'.
- **Historical Evidence**
  - Ancient Egyptians, Greeks and Romans adopted various audit procedures to ensure that the accounts to be heard were free from errors and frauds
  - Auditing associated with government accounts

## From Industrial Revolution

- Term 'Audit'
  - Associated with 'Hearing of Accounts'
- Emergence of Limited Liability Corporates
  - In Eighteenth century and subsequent legislations
  - Auditing started getting closely linked with examination of accounts, books and relevant documentary evidence.

## Twentieth Century

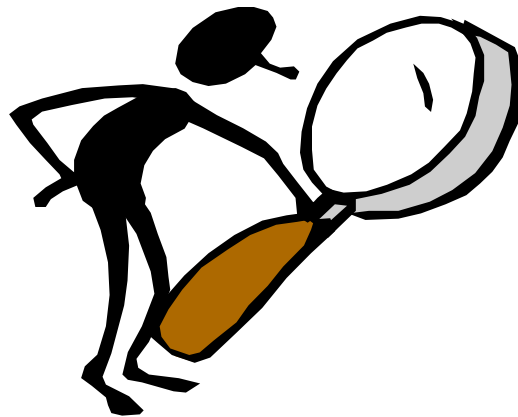
- Developments have led to further enlargement in the scope of the term 'audit'
  - Increase in size and complexity of business
  - Acceptance of the idea of Social Responsibility of business
  - Increase in the level of consumer awareness &
  - Other such factors.

## Enhanced Scope of Audit

- **Earlier**
  - The term 'audit' referred only to financial audit with a limited scope
- **Now**
  - Includes any evaluation process undertaken to establish adherence to certain norms for accomplishing a stated object

# Auditing Defined

Nature of Auditing





## Definition

According to **General Guidelines on Internal Auditing** issued by the Institute of Chartered Accountants of India :

*“Auditing is a systematic and independent examination of data, statements, records, operations and performance (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report.”*

## Key Phrases - Merit Attention

- Systematic
  - An audit should be carefully planned.
- Independent
  - The auditor should not be susceptible to any influence or pressure from client or anybody else.
- Data, Statements, Records, Operations and Performance \*
  - Indicates the scope of audit

## Key Phrases - Merit Attention - 2

- Stated Purpose
  - Clearly define
- Perceives and Recognises the Propositions before him for Examination
  - Have a clear idea about propositions he is examining
- Collects Evidence
  - Collect relevant evidence depending upon the proposition he needs to examine

## Key Phrases - Merit Attention - 3

- Evaluates Evidence
  - Evaluate it on the basis of his professional knowledge and skill
- Formulates Judgment/ Opinion
  - Communicated through Audit Report
  - Format and Contents of Audit Report may vary

## Definition of Financial Audit

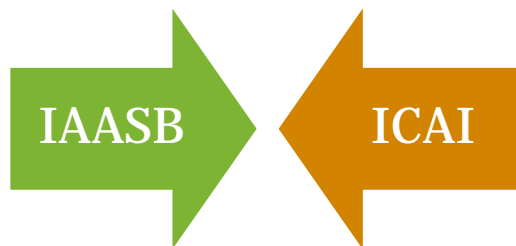
“ An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, and such an examination is conducted with a view to express an opinion there on. ”

The following points are important:

1. This definition limits itself to financial audit.
2. Financial audit can be extended to all types of entity.
3. It states that the objective of financial audit is to express an opinion.

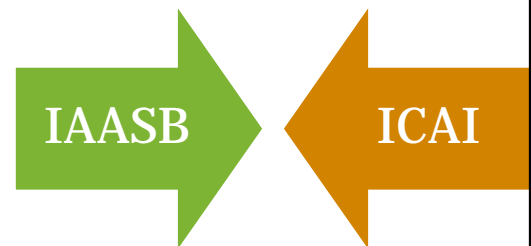
# Auditing Standards

An Introduction



## Standards on Auditing

1. Role played by International Auditing and Assurance Standards Board (IAASB) towards developing uniform Standards on Auditing.
2. Role played by Auditing and Assurance Standards Board , ICAI



# International Auditing and Assurance Standards Board (IAASB )

An Introduction



International  
Federation  
of Accountants

Leading the development of the global accountancy profession



## Uniform Standards on Auditing

- International Auditing and Assurance Standards Board (IAASB ) a standing committee of International Federation of Accountants (IFAC)
- Objective of IAASB
  - To serve the public interest
  - To enhance the quality and uniformity of practice

## Uniform Standards on Auditing - 2

### **Role of IAASB**

- The IAASB establishes high quality auditing standards called International Standards Auditing (ISAs) \* and guidance for
  - Financial statement audits;
  - Other types of assurance services on both financial and non financial matters; and
  - Other related services.
- It publishes other pronouncements on auditing and assurance matters

# Auditing & Assurance Standards Board - AASB

Role in Standard Setting in India



## Role of AASB

- ICAI is a member of IFAC
- AASB is its body which
  - Reviews existing and formulates new Engagement Standards, Standards on Quality Control and Statements on Auditing.
  - Develops and reviews Guidance Notes.
  - Formulates General Clarifications, where necessary.
  - Formulates and issues Technical Guides and Practice Manuals.

## SQC & Engagement Standards

- Standard on Quality Control (SQC)
  - The Mother Standard
- Engagement Standards
  - Standards have been grouped and are called Engagement Standards
  - Each group has been allotted a number
  - Mandatory for audit of financial statements
  - Audit report should draw attention to material departures there from

## Standard Setting Process

Study Groups prepare an Exposure Draft

Exposures Draft issued for Suggestions and Comments

Draft Engagement Standard finalized and submitted to the Council of ICAI

ICAI considers the Draft of proposed SA with requisite updates

The Engagement Standard is issued under the authority of ICAI

## Engagement Standards

Standards on Auditing relating to audit of financial information	Standards on Review Engagements (SREs) relating to review of financial information	Standards on Assurance Engagements (SAEs) relating to assurance engagements other than audit or review of financial information	Standards on Related Services (SRSs) relating to related services as specified by ICAI.
100- 999	2000 - 2699	3000 - 3699	4000- 4699

## Guidance Notes

- Recommendatory in nature
- Rationale of issuing the Guidance Notes
  - To assist members in resolving issues arising out of certain auditing standards
  - To help members tackle certain peculiar situations faced by them in discharging their professional responsibilities.



## Statements on Accounting and Auditing

- Mandatory
- Duty of the Auditor to
  - Examine whether the 'statements relating to accounting matters' have been complied with for the presentation of financial statements
  - Ensure that 'statements relating to auditing matters' have been followed.

# Auditing Objectives



## Evolution of Primary Objective

The detection and prevention of frauds and errors was the primary objective of auditing until well into the twentieth century. The auditors were required to report on whether the financial statements gave a 'true and correct' view of the state of affairs of a business.

- Managements manipulated the financial statements. (*Royal Mail Steam Packet Company's case*)
- Broadening of audit objectives

Expression of opinion about the truthfulness and fairness of financial statements has now become the primary object of an audit and the detection and prevention of frauds and errors has been relegated to secondary status. Thus, emphasis of audit has now shifted from 'arithmetical accuracy' to 'reliability' of financial statements.

## Primary Objective

- SA – 200 states that the auditor has to render an opinion on the financial statements.
- An audit process for all business entities must culminate in expression of opinion.
- This object has statutory recognition in India.
- Auditor's opinion is no guarantee to the future viability of the business.

## Auditor's Duty

Auditor's duty with regard to detection and prevention of frauds and errors laid down by

- Various legal decisions and
- Professional pronouncements
- Legal perspective
  - *Re- The London and General Bank Ltd.*
  - *Re - Kingston Cotton Mills Co.*
  - *Re- Westminster Road Construction and Engineering Co.*

## SA 240: Professional Perspective

- Has been laid down by SA 240:
  - The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements
- The general principles therein are summarised below :
  - Primary Responsibility
    - Those charged with governance of the entity and management.
  - Secondary Responsibility
    - Auditor

## SA 240: Professional Perspective - 2

- Responsibilities of the Auditor
  - Obtain Reasonable Assurance
  - Detect cleverly concealed Frauds
    - That are difficult to detect
  - Detect Management Fraud and Employee Fraud
  - Maintain an Attitude of Professional Scepticism

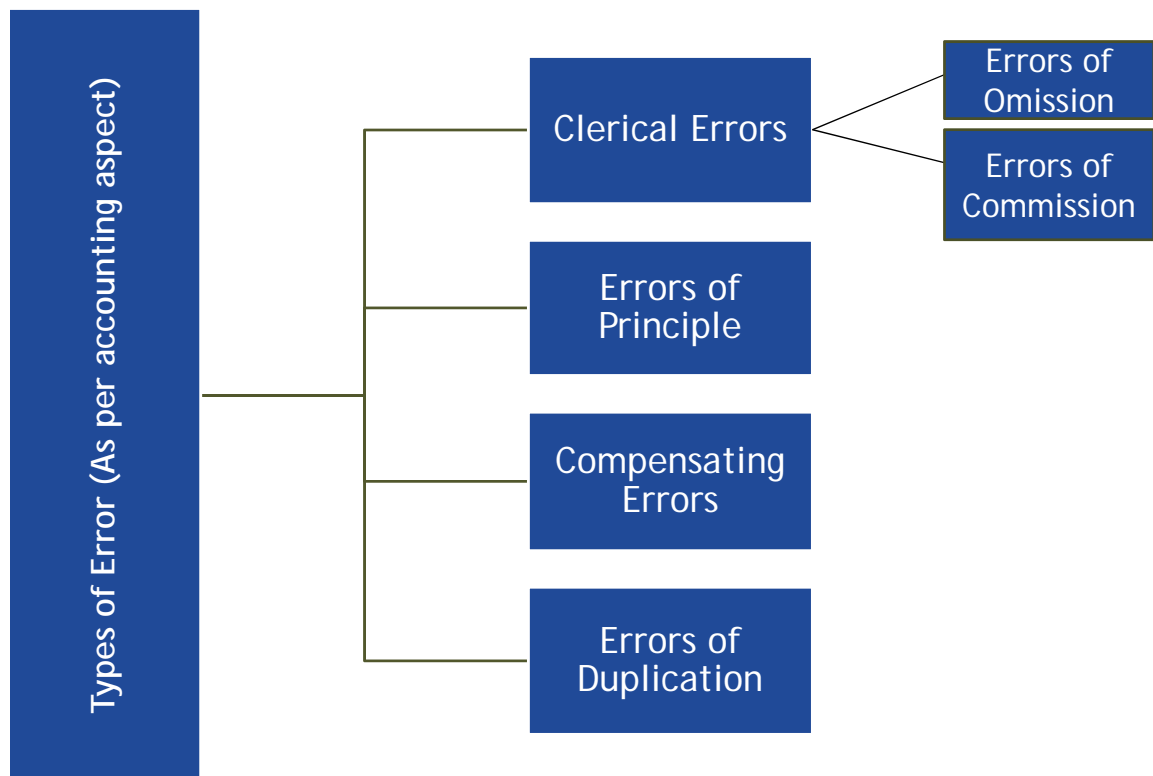
# Type of Errors & Frauds

An Introduction

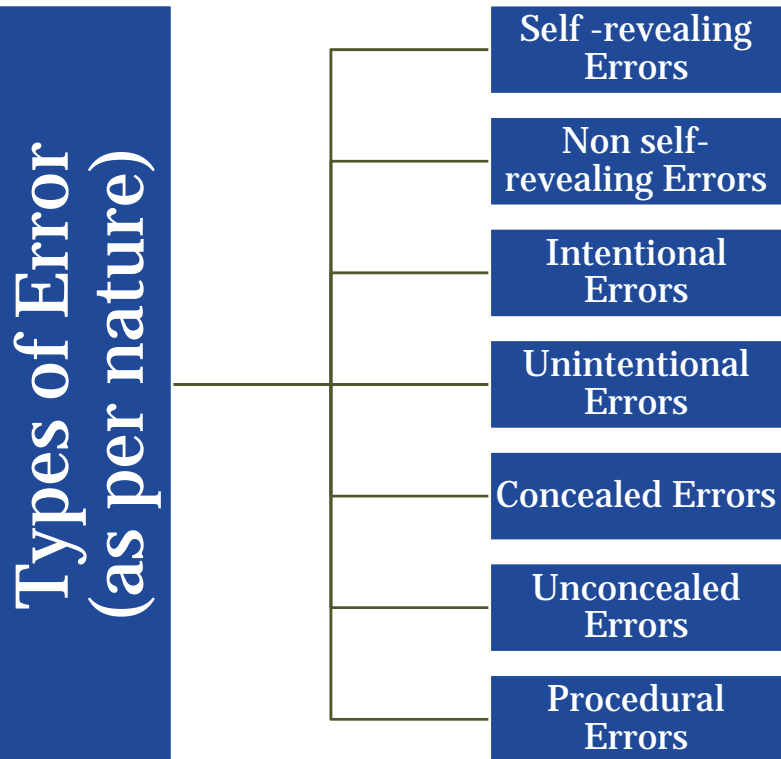




## Type of Errors (As per Accounting Aspect)

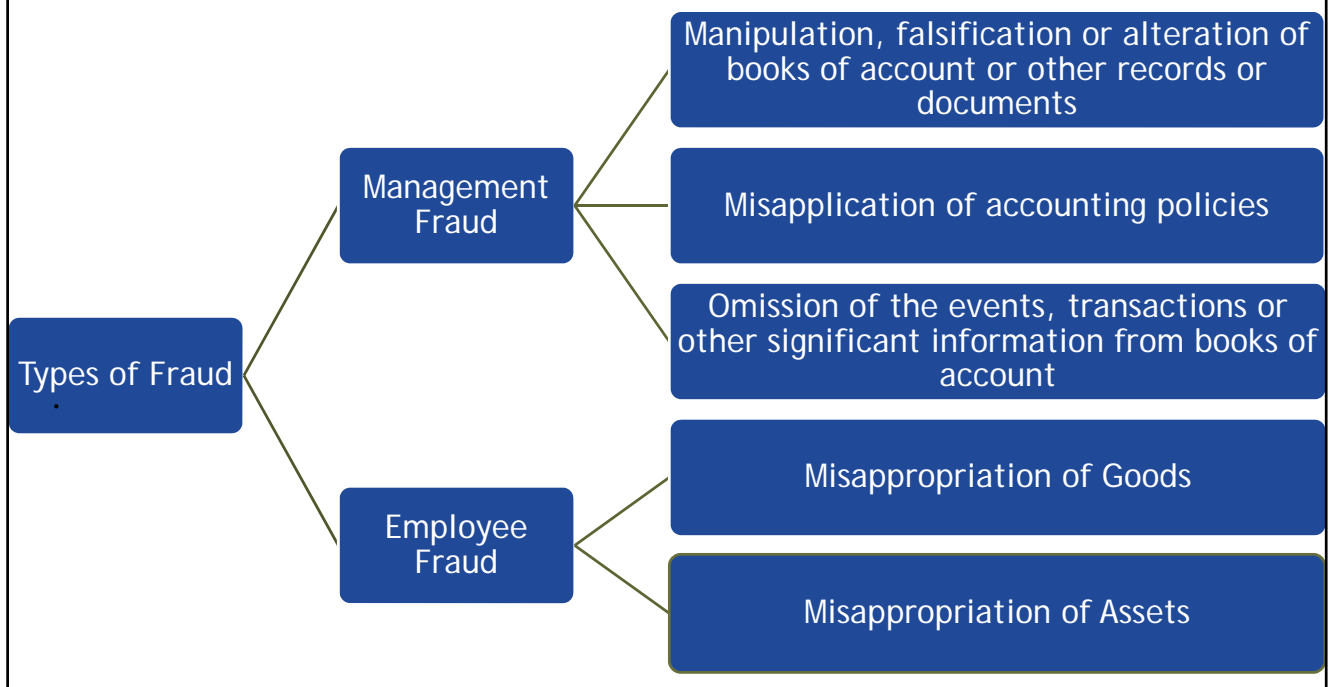


## Types of Error (As per Nature)



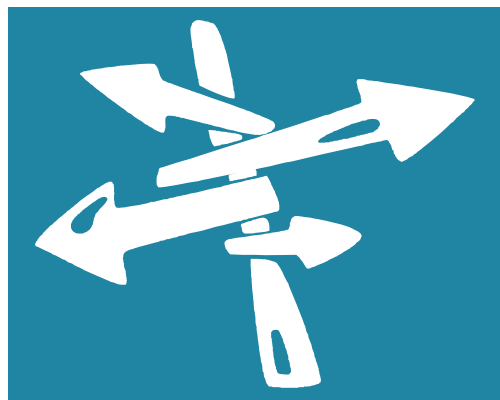
## Intentional Errors or Frauds

Fraud refers to intentional misstatement which is material to the financial statements.



# Basic Principles Governing an Audit

An Introduction.



## Basic Principles Governing an Audit

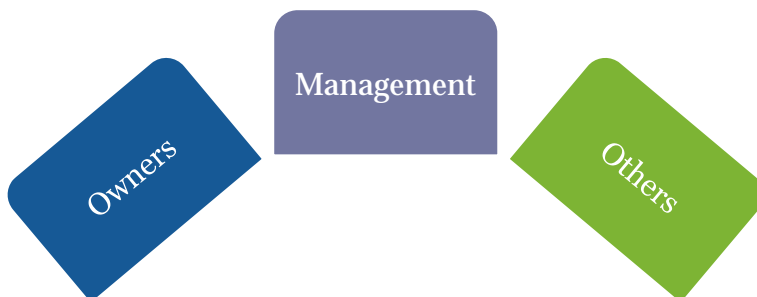
1. Integrity, Objectivity and Independence \*
2. Confidentiality
3. Skills and competence \*\*
4. Work performed by others
5. Documentation
6. Planning
7. Audit evidence
8. Accounting system and internal controls
9. Audit conclusions and reporting

## Principal aspects to be covered in audit

- Internal control system
- Review of systems and procedures
- Routine checking/Arithmetical accuracy
- Vouching
- Accounting principles
- Books and statements
- Verification of assets
- Verification of liabilities
- True and fair view
- Statutory compliance
- Report

# Advantages of Auditing

To User Groups



## To Owners - Present & Potential

- Basis for relying on Financial Statements
- A check on the Integrity of Person
  - at the helm of affairs



## To Management

- Basis for establishment of and improvement in the control system
- Helps in dealing with Third Parties
- Ensures compliance with Legal Requirements in certain situations

## To Others

### To Employees

- As a basis for negotiating higher wages or bonus.

### To Potential Creditors

- e.g., bankers and suppliers
- Provides a database for taking credit decisions.

### To Analysts

- e.g., underwriters and credit rating agencies
- Supplies Required Information

### To Monitoring Agencies

- e.g., regulatory agencies such as SEBI and stock exchanges
- Provides a basis for monitoring the financial information.

# Limitations of Auditing

(as per SA 200 Revised)

## Limitations of Auditing

- Minimisation and not Elimination of Errors
- Inconclusiveness of Evidence
- Exercise of Judgment
- Nature of audit procedures

# Auditing & Other Subjects

Relationship

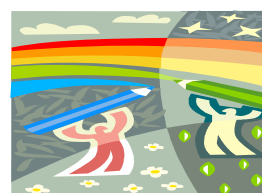
## Relationship of Auditing

Accounting	• Opinion about the reliability of the financial statements.
Statistics	• Uses theory of sampling to form his judgment
Economics	• Economic Concepts and Economic Environment
Law	• Mercantile and Corporate laws
Ethics	• Code of Conduct.
Data Processing	• Computerised Accounting
Behavioral Science	• Behavioral aspects of Human Beings

## Distinctions

- Auditing and Investigation
- Private audit and Statutory audit
- External auditor and Internal auditor

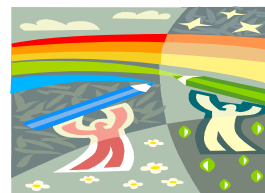
## Summary - 1



- The term 'audit' no longer refers only to financial audit with a limited scope
- The primary objective of a financial audit is to ascertain a true and fair view of the state of affairs and working results of an enterprise.
- IAASB works towards developing uniform Standards on Auditing at international level
- AASB reviews existing and formulates new Engagement Standards, Standards on Quality Control and Statements on Auditing.



## Summary - 2



- There are nine Basic Principles Governing an Audit
- Advantages of audit accrue to different user groups
- There are certain inherent limitations of audit process
- Auditing draws elements from other disciplines



Thank You

