

# Diploma in Financial Management & Accountability

- A joint initiative of TISS & FMSF

## Course Material



Audit

Paper - VII

Module - IV

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<p style="text-align: center;"><b>UNIT- 3</b></p> <p style="text-align: center;"><b>AUDITORS &amp; AUDITORS REPORT</b></p>
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### **3.1. AUDITOR**

The person conducting audit is known as the auditor. He makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflects a true and fair view. Auditing, especially of companies and for public purposes is assigned to the persons having recognized professional training and qualification. In India, under the authority of the Companies Act, 1956, only Chartered Accountants are professionally qualified for the audit of the accounts of companies. By and large, it is chartered accountants or a firm whose all partners are chartered accountants can act as auditors in India.

### **3.2. FUNCTIONAL CLASSIFICATION OF AUDITORS**

On the basis of function, auditors can be classified, into two broad categories, external auditors and internal auditors.

**3.2.1. External Auditors:** They are the persons who are external vis-à-vis to the organization. When an external auditor is appointed under a particular statute, he is called statutory auditor. Their scope of work is determined by the statute under which they have been appointed. They are independent of the management of the organization which is responsible for preparation of books of accounts. The statutory auditors have to satisfy themselves that the accounts to be presented to the shareholders show a true and fair view of the profit/loss and of the company's financial affairs.

**3.2.2. Internal Auditors:** They are internal vis-à-vis to the organization. They are appointed by management generally directors. They are responsible to the management. Their scope of work is determined by the

management. They are not independent vis-à-vis the management of the organization. The scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages, production audit, performance audit, etc. The internal auditor has opportunity to know the affairs of the company more intimately.

### 3.3. LETTER OF AUDITOR'S ENGAGEMENT

This refers to the letter written by the auditor to his client documenting and confirming his acceptance of the appointment, the objective and scope of his responsibilities to the client.

According to guidance note on Audit Engagement letters issued by ICAI, "The purpose of engagement letter is to confirm verbal arrangements by defining the nature and scope of work and auditor's responsibilities which help in avoiding misunderstanding with respect to engagement. While in certain engagements, the objective, scope and the auditor's obligations are established by law, an engagement letter will be informative for a client."

The form and content of audit engagement letters may vary for each client, but they should generally include reference to :-

- a) The objective of the audit of financial information.
- b) Management's primary responsibility for maintenance of books and records and for the financial information.
- c) The scope of audit, including period to be covered by audit.
- d) A reference to applicable legislation, regulations or pronouncements of ICAI.
- e) The nature or form of any reports or other communication pursuant to the engagement.

- f) Access to records, documents and other information required in connection with the audit.
- g) The possibility that some material misstatements of financial information resulting from fraud and error, may not be detected.

The auditor may also include in the letter :

- a) Arrangement regarding the planning of the audit.
- b) Expectation of receiving from management written confirmation or representations which are made in connection with the audit.
- c) Description of any other letter or reports he expects to issue to the client.
- d) Basis on which fees are computed and billing arrangements.
- e) Request to the client to confirm the terms of engagement by acknowledging receipt of the engagement letter.

#### **3.4. INDEPENDENCE OF AUDITORS ENGAGEMENT**

The concept of independence refers to the necessity of the auditor being not under the influence of the management of the enterprise under audit. An auditor should be free from bias and prejudice and should possess an independent approach.

The principles of objectivity and independence highlight the true nature of an auditor's function. Like a judge, an auditor has to form his opinion on the basis of the evidence rather than on the basis of any pre-conceived notions. The auditor's opinion should not be influenced by personal prejudice or bias. Further, the auditor should be independent of the entity under audit both in fact and in appearance. He should not only be independent in reality, but the others must also not doubt his independence. The following propositions illustrate these principles.

- a) An auditor should not have financial involvement with or in the affairs of the entity under audit.
- b) An auditor should not be an employee or a director of the entity under audit.

#### **Measures to ensure Independence of Auditors -**

- a) The Companies Act has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking an audit of limited companies, provisions relating to ceiling on the number of audit that can be undertaken by Chartered Accountants, provisions requiring special resolution for appointing auditors in certain cases and other provisions on appointment, reappointment and removal of auditors designated to invert this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users.
- b) The vast powers of access given to the auditor to the books of accounts and other documents of the company are specifically designated to give independence to the auditors.
- c) The power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence.
- d) The enactment of specific instances of misconduct in the schedule of the Chartered Accountants Act is yet another attempt to keep the independence and professional competence of the accounting profession.

#### **3.5. AUDITING & ASSURANCE STANDARDS (AAS)**

The institute of Chartered Accountants of India has issued various Auditing & Assurance Standards (AAS) which will apply whenever an independent audit is carried on that is, in the independent examination of financial information of any

entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. While discharging their attest function, it will be the duty of members of the Institute to ensure that the AASs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom.

The Council of the ICAI has so far issued 35 Auditing & Assurance Standards which should be followed by the Auditors while conducting an independent audit.

### 3.6. CONTENTS OF AUDIT REPORT

An audit report normally describes the scope of the audit and the opinion of the auditor.

The “scope” part of an audit report consists of a representation as to the work performed. It shows the extent to which the auditor has carried out his examination and the nature of such examination. The “opinion” part contains an informed judgment or belief of the auditor. In the audit report, an auditor is required to express an opinion on certain matters. For example, in the case of a financial audit, he has to state whether in his opinion the financial statements exhibit a true and fair view of the affairs of the organization under audit or not.

International Standard on Auditing 700 on *The Auditor’s Report on Financial Statements* provides guidance on the form and content of the auditor’s report issued after an examination of financial statements. According to the Standard, the basic elements of the auditor’s report are as follows :

- a) *Title* - An appropriate title such as *Auditor’s Report* helps the reader to identify the report and to distinguish it from reports issued by others.
- b) *Addressee* - The report should be appropriately addressed. For example, in the case of a statutory audit of a company, the report is addressed to shareholders.

- c) *Identification of financial statements* - The financial statements can be identified by including the name of the entity and the date of, and period covered by, the financial statements.
- d) *Responsibility* - The opening paragraph should state that the financial statements are the responsibility of the entity's management and that the responsibility of the auditor is to express an opinion thereon.
- e) *Reference to auditing standards or practices* - Such a reference in the report assures the reader that the audit has been carried out in accordance with established standards or practices.
- f) *Description of audit* - The report should describe what the audit is. The audit should be described as including an examination, on a test basis, of evidence supporting the financial statements, assessment of accounting principles followed and significant estimates made, and overall evaluation of financial statement presentation. It should also be stated that the audit provides a reasonable basis for the auditor's opinion.
- g) *Opinion on the financial statements* - The report should clearly set forth the auditor's opinion on the entity's financial position and operational results, e.g., "the financial statements give a true and fair view". A reference to accounting standards should be made in order to advise the reader of the framework within which the auditor has reached his professional opinion.
- h) *Signature* - The report should be signed in the name of the audit firm or the personal name of the auditor or both, as appropriate.
- i) *Auditor's address* - The report should name a specific location, which is usually the city in which the auditor maintains his office.
- j) *Date of the report* - The report should be dated.

**SELF ASSESSMENT QUESTIONS**

- i) Define auditors and normally who can be appointed as an auditor?
- ii) What are the difference between External and Internal Auditor?
- iii) Why the auditor writes the Letter of Engagement to the client?
- iv) Discuss about the concept of independence of an auditor and how it can be achieved at the time of appointment of the auditor?
- v) What are the two main components of the audit report?
- vi) What are key issues that should be contained in an audit report?