CHAPTER
1

# NATURE, OBJECTIVE AND SCOPE OF AUDIT
## (VERY IMPORTANT CHAPTER)

I presume every student must have had basic idea about "Auditing" and without which he would not have joined CA course.

***Do you know:***

- What is the meaning of "Audit"?
- Who performs the Audit and what should be his qualifications?
- Why to perform audit?
- What are the primary objectives of audit?
- Whether the auditor is **responsible** to find out the frauds & errors in the entity?
- What are the advantages of audit?
- How to start and close the audit? *(Imagine you are in a company)*

Think about these questions for some time. That will help you.

Generally, students do have some misconceptions on this subject. This chapter will help you to get an overall idea about the concept of "auditing". All the words are inter-linked, so you must read it with utmost concentration.

We suggest you to **read** this chapter **at least three times** very carefully so that your basics will be strong and you will be geared up to proceed to the next chapters.

## Q 1: What do you mean AUDIT?

***Answer***

Audit is an **independent examination** of **financial information** of an **entity,** irrespective of **its form, nature and objective**, with a view to **express an opinion** on such financial information

**Refer Note 1**

**Refer Note 2**

**Refer Note 3**

**Refer Note 4**

*Read the definition at least three times*

Let us understand each and every word of the definition now.

## NOTE 1 - Financial Information

**Let us understand completely about financial statements in this note.** *(CA IPCC May 2017)*

Financial information is often contained in financial statements.

Broadly speaking 'Financial statements' are a set of documents which include the following (along with the purpose of each statement).

| Document Name | | It Presents |
|---|---|---|
| 1. | Balance sheet / Statement of affairs | The **financial position** of the entity as on a **particular date** (i.e., generally 31st March); |
| 2. | Statement of Profit and Loss/Income Statement | The financial result of its operations during the **period**; |
| 3. | Cash Flow Statement | The **movement (in and out)** of cash and cash equivalents **during the period**; |
| 4. | Statement of Changes in Equity | The movement of Share capital and Reserves & Surplus during the period; |
| 5. | Notes to Accounts | (a) The Significant accounting policies and procedures adopted in preparation and presentation of above financial statements;<br>(b) Details of the items presented in the financial statements;<br>*Say in Balance sheet – you may find just PPE – 1,000 Crore. But in the notes – the entity explains what are included in PPE in detail.* |

Financial statements **do NOT include** the following statements:

1. Director's Report;
2. Statement by the Chairman;
3. Discussion and analysis by management.

***Asked in Exam***

Write short notes on general purpose Financial Statements. ***(CA IPCC – Nov 2005)***

## Q 2: What do you mean by General purpose financial statements and Special purpose financial statements?

*Answer*

Financial statements which are **used by varied users** like creditors, lenders, government, shareholders are known as **general purpose** financial statements.

However, if financial statements are prepared only **for a specific purpose,** such financial statements are known as special purpose financial statements.

***For example,*** financial statements prepared for the purpose of Bankers on Cash basis;

## Q 3: Who prepares 'Financial statements? (Read carefully)

*Answer*

As per Section 129 of the Companies Act, 2013 – Every year, Board of Directors shall submit the financial statements to the members in the Annual General Meeting (AGM);

Governing body of the entity is responsible to prepare financial statements.

***For Example***

| Form of Business Organization | Person responsible to prepare FS |
|---|---|
| Company | BOD |
| Partnership Firm | Partners |
| Trust | Trustees |
| Sole proprietorship | Proprietor |

As you know governing body changes from entity to entity, hence from now onwards - Instead of naming them BOD, partners, trustees, etc. – We will use "**Those Charged With Governance" or "TCWG" in its place.**

*'Charged' means – who is empowered to govern.*

## Q 4: Why to audit "from the point of view of a company"?

*Answer (read carefully – point by point)*

- As you know – Members / Shareholders of the company are the real owners of the company;
- As the members of the company cannot run the business together (especially listed companies), they **appoint Board of Directors**.
- BOD is ultimately responsible to the members. BOD creates the hierarchy, establishes the controls and runs the business through the management;
- BOD is responsible to prepare the financial statements. (Just imagine, how to ensure whether these Statements give true and fair view?)
- To check and report on the financial statements, **members** of the company **appoint an auditor**. In the case of a company, it is a statutory requirement U/s 139 of the Companies Act, 2013 to appoint an auditor– hence, such auditor is called "**Statutory auditor**".

*I hope you understood it.*

## Q 5: Is there any difference between "TCWG" and "Management"?

*Answer*

Let me explain from the point of view of a company;

Board of Directors are the TCWG in case of a company – They take **all the operating and financial decisions of the company** in the board meetings. BOD includes Managing director, Whole time directors (Executive directors) & Part time directors (non-Executive directors).

***Who executes the decisions taken in the Board?***

This **execution work is performed by Management:** i.e., one level below TCWG. Generally, management includes ALL Wholetime directors (executive directors) and others like Chief executive officer, Chief operating officer, etc.

Generally, in case of small companies – There won't be any difference between TCWG & Management as they do both the jobs, i.e., decision making as well as execution;

*I hope you understand this concept*

Practically, though TCWG is responsible to prepare financial statements, it is – management who prepares the financial statements under the guidance of TCWG.

## Q 6: Who are the stake holders of an entity and how are financials useful to them?

*Answer*

The following table explains the usefulness from the point of view of different stakeholders:

| Stake holders / Users | Purpose |
|---|---|
| Proprietor/Shareholders | To analyse performance, profitability and financial position of the entity and accordingly decide whether to hold / sell the shares (in case of shareholders). |
| Management | For day-to-day decision-making and performance evaluation; |
| Employees | To assess their growth prospects as well as bonus entitlement; And ESOPs if they are based on performance; |
| Lenders (Give money) | To determine the financial position of the company to decide whether to given loan or not? It also helps them to determine the ability of the entity to make the payments on debts by calculating debt service coverage ratio, interest coverage ratio, etc. |
| Suppliers (Provider goods/ services) | To determine the **credit worthiness** of the company in order to give credit |
| Customers | To know the general business viability before entering **into long-term** contracts and arrangements; |
| Government | To ensure **prompt collection of direct and indirect tax** revenues and to decide eligibility for any Government grants; |

| Stake holders / Users | Purpose |
|---|---|
| Prospective Investor | To assess the solvency and future prospects of the organization. Decides whether to buy the shares or not? |

## Q 7: What are other Responsibilities of Management of the entity?

*Answer*

Besides preparation of financial statements, management's other responsibilities include:

- The maintenance of adequate accounting records and internal controls (will discuss this term in detail in next chapter).
- The selection and application of accounting policies and
- The safeguarding of the assets of the enterprise
- Compliance with applicable laws and regulations

## NOTE 2 – Entity irrespective of its form, nature and objective

As per the definition

Independent examination of financial information of an "entity".

It means **any entity – irrespective of its form –** means it can be a Company, Partnership firm, Limited Liability partnership (LLP), a Trust, a Society, etc.

**Irrespective of Nature of business –** it can be a manufacturer, service provider, software, real estate, etc.

**Irrespective of Objective –** means it can be a profit oriented OR Non-profit-oriented organisation.

## NOTE 3 – Independent Examination

The auditor should be **independent.**

## Q 8: What is the "Concept of Auditor's Independence"?

*Answer*

- ✓ There is **no definition** for independence;
- ✓ Independence is a **state of mind** in which one feels free & it is an attitude of mind.
- ✓ Audit objective is to express an opinion on financial information; Auditor should be in a position to express his opinion on the financial statements; Hence, independence is a prime requisite for the auditor;
- ✓ The judgment of the person is **NOT subject to the wishes or directions of another person** who might have engaged him and also **not subject to his own interest;**
- ✓ The Companies Act, 2013 – safeguards the auditor's independence with provisions like
    - o Section 141(3) – Auditor should not hold any share in the company *(If the auditor has interest in the company, he cannot perform his duties independently);*
    - o *Section 141(3) – Auditor or his partners or his relative cannot be officers of the company;*
    - o *Section 140(1) – Auditor cannot be removed by the company without prior permission from the Central Government and passing special resolution;*
- ✓ ICAI issued a guidance note on Independence; as per the guidance note –
    - o Auditor should **be independent and appear to be independent**; *(Just being independent is not sufficient and the users of financial statements should also feel that auditor is independent – Otherwise Auditor will lose public confidence);*
    - o These **laws may be relaxed or strengthened but the quality of independence should remain unchanged**. *(It means even if there are loopholes in the law – auditor should ensure that he is independent)*;
- ✓ Considering the above points, auditor should accept the work only when there are no threats to independence;

| *Asked in Exam* | |
|---|---|
| Discuss the concept of independence of an auditor. | ***(CA IPCC - May 2006)*** |

***Asked in Exam***

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain. ***(CA Inter - May 2019)***

***Concept capsule 1***

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain **(CA Inter - May-2019)**

***Suggested answer***

Independence" implies that the judgment 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 the entity subject to the audit.

**(a) 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

**(b) 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.

## NOTE 4 – Objective of Audit

Objectives of auditor in accordance with SA 200, are

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

The following are derived from the above two points.

(a) **Auditor's objective:** Obtain reasonable assurance that financial statements are free from material misstatement (fraud or error).

- Reasonable assurance ≠ Absolute assurance; it is a high level but not a complete guarantee.
- Audit conducted with professional competence, following Standards on Auditing (SAs).
- Audit procedures, evidence, conclusions, and opinions formed to provide reasonable assurance.

(b) **Misstatements**: Can occur due to fraud or error. Auditor seeks reasonable assurance regarding freedom from material misstatements.

- Auditor assesses the effect of misstatements on financial statements as a whole.

(c) **Purpose of obtaining reasonable assurance**: Allows the auditor to express an opinion on whether financial statements are prepared in accordance with a financial reporting framework (GAAP) (Explained in detail below).

(d) **Reporting**: The auditor's opinion is reported and communicated through a written report as required by Standards on Auditing. (Further details to be covered in subsequent parts of the chapter.)

***Concept capsule 2***

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. In the above context, explain the guiding principles.

***(RTP-Nov-2019) & (4 Marks - Nov 2020)***

***Suggested answer***

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 principles in this regard: –

- 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.
- In the case of audit, the key fundamental principles are **integrity, objectivity and professional skepticism**, which necessarily require the auditor to be independent.
- Before taking on any work, an auditor must **conscientiously consider whether it involves threats to his independence.**
- When such threats **exist**, the auditors should **either desist from the task or put in place safeguards** that eliminate them.
- If the auditor is **unable** to fully implement credible and adequate safeguards, then he must **not accept the work.**

## Q 9: What is the Audit opinion / Audit Report?

*Answer*

⇨ Auditor expresses his **opinion in writing –** that is called as "**Audit report**".

⇨ This opinion is expressed in a **prescribed format** as provided in SA 700 / SA 705 / SA 706, etc. or for tax audits, it is prescribed by the Income-tax Act, 1961- Form 3CD.

## Q 10: What is the "Concept of True and Fair view"?

*Answer*

✓ True and fair view is NOT defined in either accounting or under the Companies Act, 2013;

✓ We should understand this based on general conclusions / judgements of the courts, etc

| | |
|---|---|
| True means | Arithmetical accuracy, factual validity and completeness of the recording of the transaction and events; Complied with Financial reporting framework; |
| Fair means | Proper classification, summarization and disclosure as per regulatory requirements; No bias; presentation in FS shall reflect the economic substance rather than their legal form (Substance over form – as per AS-1) |

Look into the following examples to get an idea

❖ Company constructed an additional floor with Rs. 40 Lacs and shown it as an expense in Profit and Loss in the same year;

❖ Company has incurred loss of Rs. 25 Lacs due to fire at godown and company has shown such losses under miscellaneous expenses in the Balance sheet;

❖ Secured loan received from State Bank of India amounting to Rs. 50 Lacs by giving the building as security but not disclosed appropriately in the financial statements;

❖ As there is loss in the CY, depreciation of Rs. 25 Lacs has not been provided.

All the above points do not give true and fair view and it misleads the users of financial statements;

True and fair is mentioned in some of the sections of the Companies Act, 2013

✓ Sec. 128 – Every company shall maintain proper books of account. Proper books of Account means preparing books of accounts by following Double entry system of accounting and Accrual basis;

✓ Sec 129 - All the matters of financial statements are to be disclosed in accordance with **Schedule III** of the Companies Act, i.e., the Balance Sheet and Profit and Loss account should be prepared in accordance with **Part I and Part II of Schedule III** respectively.

- ✓ Sec. 129 – Financial statements should comply with Accounting standards so as to provide true and fair view;
- ✓ True and Fair view is a **matter of judgment** and depends on facts and circumstances of each case. To ensure T&F view the Auditor has to ensure the following:
  - o The assets are **neither undervalued nor overvalued**;
  - o **No material asset OR liability is omitted;**
  - o The charge on assets (if any) is properly disclosed;
  - o All the matters of financial statements are disclosed in accordance with Schedule III of the Companies Act;
  - o Accounting principles are **consistently** followed (AS-1);
  - o All unusual or exceptional items are disclosed appropriately (AS-5)

***Asked in Exam***

Under what circumstances/conditions the financial statements are considered to present a "true and fair" state of affairs? ***(CA IPCC- Nov 2005)***

What constitutes a 'true and fair' view, is the matter of an auditor's judgement in the particular circumstances of a case. In order to ensure 'true and fair' view, auditor has to review certain points. Mention any such 5 (five) points in brief. ***(CA Inter- May 2018)***

## Q 11: Is there difference between 'Opinion' and 'Certificate'?

*Answer*

- ⇨ **Opinion** means **one's point of view** towards any given fact; One person's opinion may vary with another person's opinion; it involves professional judgements / estimations/ assumptions, etc. In case of opinion, accuracy is not possible – Only fairness is possible;
- ⇨ **Certificate** means **establishing a given fact**. Certificate confirms the correctness / accuracy. It cannot be different for two persons and if certificate goes wrong – issuer of certificate is punishable. There is no involvement of professional judgement;
- ⇨ **"Auditor usually issues opinion and does not certify financial health of an organization."**

## Q 12: What is "Financial Reporting Framework" (FRF)? *(CA IPCC Nov 2017)*

*Answer*

In simple words – we can call it as Indian GAAP (Generally accepted accounting principles);

In general, Financial reporting framework includes the following:

(a) Accounting standards / Ind AS;

(b) Statutes, regulations like Schedule III of the Companies Act, 2013 and Ministry of Corporate Affairs (MCA) notifications;

(c) Court decisions;

(d) Professional and ethical obligations in relation to accounting matters (Guidance notes issued by ICAI);

(e) General and industry practices widely recognised and prevalent; and

(f) Accounting literature;

The financial reporting framework has to be adopted by management and TCWG for the preparation and presentation of the financial statements. The selected framework should be **acceptable in view** of the **nature** of the entity and **the objective** of the financial statements, or that is **required by law or regulation**.

## Q 13: What do you mean by the term "Misstatement"?

*(You will read this word number of times in this book and throughout your audit life)*

*Answer*

Misstatement is the difference between (a) and (b) below:

(a) The Amount, classification, presentation, or disclosure which is **reported in Financial Statements**; and

(b) The Amount, classification, presentation, or disclosure **that is required to be presented as per the applicable Financial Reporting Framework.**

**Misstatements can arise from error or fraud.**

***For Example***

*AS-2 "Inventory valuation" (Financial Reporting Framework) requires to follow either FIFO or weighed average method for valuation of inventory; and*

*If an entity applies LIFO, it would be a departure from what was expected to be followed, i.e., FRF. This will result in misstatements.*

## Q 14: Fraud & Errors (Is it the duty of Auditor to detect & correct the frauds & errors?)

1. **Fraud may be – 'Misappropriation of assets' and 'Fraudulent reporting'.**
2. Error is an **unintentional mistake**. Some of the errors are **self-revealing,**. i.e., they are clearly identifiable.

   ***For example:*** Partial omission (Trial Balance will not tally). Wrong entries in bank account ledger (BRS will show up the error). Entering a transaction of Mr. X in Mr. Y Account. (When external parties statements are checked, that will not tally). Wrong Entry of Purchase of Furniture in Purchase account. (Physical verification of inventory will show up the difference).
3. Errors are – Error of omission, Error of commission, Error of Principle, Compensating error.
4. **The primary responsibility for the prevention & detection of fraud rests with Management & TCWG.** It is important that management place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence (punishment), which could persuade individuals not to commit fraud. *(SA 200)*
5. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of **professional skepticism** (*Explained later*) throughout the audit.
6. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures, he cannot be held responsible for the same. Management will only be held responsible in such cases.
7. The liability of the auditor for failure to detect fraud exists **only when such failure is clearly due to not exercising reasonable care and skill**. If the same cannot be proved, then auditor will not be held responsible.
8. **Detection & Correction of fraud & error is not the primary duty of the auditor.** But if auditor comes across instances of frauds & errors, then it is the part of his audit to suggest the corrective measures to avoid the repetition of such mistakes. (SA 200)
9. The auditor also has the responsibility to communicate the misstatement to the management on a timely basis & discuss it and rectify. If management fails to do so, then auditor shall mention the same in his report.

## Q 15: What are included in "the Scope of Audit"?

Scope refers to range or reach of something. As you know, financial statements and accounting records are prepared by the management of the entity. If the same are verified by a qualified Chartered Accountant and express opinion on the same, it will give confidence to the users of financial statements that they can depend on the financial statements and take their economic decisions.

Let us understand what all included in the scope of Audit

**(1) Coverage of All Aspects of Entity:**

- Adequate organization of the audit to cover all relevant aspects of the entity related to the audited financial statements.

**(2) Reliability and Sufficiency of Financial Information:**

- Auditor's satisfaction that information in accounting records and source data is reliable and sufficient.
- Assessment through the study of accounting systems, internal controls, and appropriate tests, enquiries, and procedures.

**(3) Proper Disclosure of Financial Information:**

- Determination of whether relevant information is appropriately disclosed in financial statements.
- Compliance with applicable statutory requirements.