1 CHAPTER

Nature, Objective and Scope of Audit

1.1 - Meaning, Objectives and Scope of Audit

Q.1 The person conducting the audit should take care to ensure that financial statements would not misled anybody. Describe briefly the points the auditor should ensure for.

Ans : Points to be ensured that F.S. not misled anybody:

Auditor engaged to perform the task of performing audit need to ensure the following:

(*a*) Ledger balances agree with the entries made in the books of account.

(*b*) Sufficient and Appropriate evidences are available for entries made in books of account.

(*c*) All transactions are being recorded in books of account, *i.e.* there is no omission.

(*d*) Information contained in the financial statements is clear and unambiguous.

(*e*) Amounts shown in financial statements are properly classified, described and disclosures are made in conformity with applicable Accounting Standards.

(*f*) Financial statements reflect true and fair view of financial results and financial position.

Q.2 The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

Or

State the objectives of Audit according to SA 200

Ans : Objectives of Audit:

(*a*) The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to **express an opinion** on such financial statements.

(*b*) The auditor's opinion helps determination of the **true and fair view** of the financial position and operating results of an enterprise.

(*c*) The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

(*d*) Auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

Q.3 List the points that merit consideration in regard to scope of audit.

Ans : Points to be considered in determining Scope of Audit:

1. Audit should cover the examination of all aspects of an entity relevant to financial statements.
2. Auditor should assess the sufficiency and appropriateness of the information contained in the accounting records and other source data. For this purpose, auditor should

(*a*) evaluate accounting systems and internal controls.

(*b*) perform necessary tests, enquiries and other verification procedure of accounting transactions and account balances.

3. To determine whether the information is properly disclosed in the financial statements, audit may involve

(*a*) comparing the financial statements with the underlying records.

(*b*) considering the judgments used by management in preparing the financial statements.

4. Auditor is not expected to perform duties which fall outside the scope of his competence.
5. Limitations, if any, on the scope of audit that impair the auditor's ability to express an unmodified opinion should be set out in his report.

Q.4 State briefly six important aspects to be considered by an auditor while conducting an audit.

or

State the matters which the statutory auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall audit approach.

or

State the principal aspects to be covered in an audit concerning financial statement of account.

[Nov. 15 (5 Marks)]

Ans : Aspects to be covered in Audit:

1. **Examination of Accounting System & Internal Control**
   - To ascertain whether it is appropriate for the business and helps in proper recording of all the transactions.
   - To determine the Nature, Timing and Extent (NTE) of Audit Procedures to be performed.
2. **Reviewing the system & procedures**
   - To find out whether they are adequate and comprehensive.
3. **Vouching of the transactions**
   - To ensure authenticity and validity of transactions.
   - To check the arithmetical accuracy of the books of account.
   - To ascertain proper distinction into capital and revenue items.
4. **Verification of Assets & Liabilities**
   - To ensure existence and valuation of the assets and liabilities appearing in the balance sheet.
5. **Statutory Compliances**
   - In case of entities governed by some law, rules or regulations, for example in case of audit of a company incorporated under Companies Act, 2013.
6. **Expression of Opinion**
   - On true and fair view of state of Affairs as reflected by Balance Sheet.
   - On true and fair view of Financial Results as reflected by Statement of Profit and Loss.
   - On true and fair view of Cash Flows as reflected by Cash Flow Statement.
7. **Reporting on Other matters**
   - As required by the law governing the entity.

Q.5 The duties of the auditor are limited to verification of the arithmetical accuracy of the books of the accounts. Comment.

Ans : Auditor's Duties:

Statement that duties of the auditor are limited to verification of the arithmetical accuracy of the books of the accounts is not correct, as besides ensuring the arithmetical accuracy of the books of the accounts, auditor is also supposed to cover a number of other aspects in the audit.

Aspects to be covered in the audit in addition to verification of arithmetical accuracy:

Refer Q. No. 4

1.2 - Types of Audit

Q.6 Discuss the types of audits required under law. [Nov. 11 (5 Marks)]

Ans : Audit required under law:

(*a*) Companies governed by the Companies Act, 2013;

(*b*) Banking companies governed by the Banking Regulation Act, 1949;

(*c*) Electricity supply companies governed by the Electricity Supply Act, 1948;

(*d*) Co-operative societies registered under the Co-operative Societies Act, 1912;

(*e*) Public and charitable trusts registered under various Religious and Endowment Acts;

(*f*) Corporations set up under an Act of Parliament or State Legislature such as the LIC of India.

(*g*) Specified entities under various sections of the Income-tax Act, 1961.

1.3 - Advantages of Audit of Financial Statements

Q.7 What is the importance of having the accounts audited by independent professional auditors? [May 01 (8 Marks)]

Or

What are the advantages of Independent audit. [May 12 (8 Marks)]

Or

Discuss the following: Advantages of Independent Auditor. [May 15 (5 Marks)]

Ans : Advantage of Audit of Financial Statement:

1. **Protect the interest of fund providers:** It safeguards the financial interests of persons who are not associated with the management of the organisation *e.g.* partners or shareholders.
2. **Moral check on employees:** It acts as a moral check on employees from committing defalcations or embezzlement.
3. **Settlement of Taxes, etc:** Auditing statements of accounts are helpful in settling of taxes, negotiating loans and for determining the purchase consideration for a business.
4. **Settlement of Trade Disputes:** Audited statements are useful for settling trade disputes for higher wages or bonus.
5. **Detection of Wastages:** Audited statements also help in detection of wastages and losses and shows the different ways by which these might be checked especially those that occurred due to absence or inadequacy of internal checks or internal control measures.

6. **Proper maintenance of books of account:** Independent audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.
7. **Appraisal of controls:** As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies etc.
8. **Admission/retirement of Partner:** Audited accounts are of great help in the settlement of accounts at the time of admission or death of the partner.
9. **Grant of License:** Government may require audited and certified statements before it gives assistance or issues the license for a particular trade.

1.4 - Inherent Limitations of Audit

Q.8 Discuss Limitations of audit. **[May 11 (8 Marks)]**

Or

"The process of auditing is such that it suffers from certain limitations". Discuss.

Or

ABC Ltd. Requested the auditor to provide for absolute assurance in respect of its ten branches scattered in Mumbai and confirm that financial statements are free from material misstatements due to fraud or error. Advise.

Ans : Inherent Limitations of Audit:

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. The inherent limitations of an audit arise from:

1. The Nature of Financial Reporting

- The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable FRF to the facts and circumstances of the entity. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

2. Nature of Audit Procedures

There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- Management & others do not provide complete information intentionally/unintentionally.
- Audit procedures used to gather audit evidence may be ineffective against fraud detection.
- Audit is not an official investigation into alleged wrongdoings.

3. Timeliness of Financial Reporting & the Balance between Benefit & Cost

- User expectation that the auditor will form an opinion on the F. S. within a reasonable period of time and at a reasonable cost.
- It results into use of Test checking and putting most of efforts over the areas having risk of material misstatement with corresponding less efforts in other areas.

4. Other Matters that Affect the Limitations of an Audit

In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

(*a*) Fraud, particularly fraud involving senior management or collusion.

(*b*) The existence and completeness of related party relationships and transactions.

(*c*) The occurrence of non-compliance with laws and regulations.

(*d*) Future events or conditions that may cause an entity to cease to continue as a going concern.

Q.9 DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the financial year 2017-2018. 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 : Management allegation as to auditor's failure to detect material misstatements:

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.

As per SA - 240, the responsibility for the prevention and detection of fraud and error rests with management through the implementation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error. Auditor's responsibility for failure to detect fraud and error can arise only due to **proven negligence**.

The relevant provisions in this regard are:

(*a*) In forming his opinion, the auditor carries out procedures designed to obtain evidence that will provide **reasonable assurance** that the financial information is properly stated in all material respects.

(*b*) Due to the inherent limitations of an audit there is a possibility that material misstatements of the financial information resulting from fraud or error may not be detected. An auditor cannot be charged for non-adherence of basic principles in the following circumstances:

- subsequent discovery of material misstatement of the financial information resulting from fraud or error;
- failure to disclose the affairs of the company kept out of books and concealed from him.

Unless it is proved that procedures undertaken by auditor in the circumstances are inadequate and improper.

Thus, if any misstatement has been detected after the completion of the audit, the same by itself cannot mean that the auditor did not perform his duty properly.

If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same.