

UNIT I

Concept, Need, and Purpose of Audit

1. Definition, Nature, Scope, and Objectives of Independent Financial Audit

Definition of Audit:

An audit is defined as an independent and systematic examination of the financial records and statements of an entity. This can be a business, government entity, or any organization. The audit aims to ascertain the accuracy and fairness of the financial statements, ensuring they reflect a true and fair view of the financial position and performance. This examination is conducted by an auditor, who is independent of the entity being audited.

Nature of Audit:

1. **Independent Examination:** The audit is carried out by someone who is independent of the entity, ensuring an unbiased opinion.
2. **Systematic Process:** The audit process follows a structured methodology, adhering to auditing standards and procedures.
3. **EvidenceBased:** Auditors rely on documentation, records, and financial data to gather evidence and form their opinion.
4. **Comprehensive:** The audit covers all areas of financial reporting, including revenues, expenses, assets, liabilities, and compliance with laws and regulations.
5. **Professional Judgment:** Auditors use their expertise and judgment to determine the reliability of financial statements.

Scope of Audit:

The scope of an audit is determined by the engagement letter between the auditor and the entity. It outlines the areas the auditor will cover and the extent of the audit procedures. The scope includes:

1. **Verification of Financial Statements:** The focus is on verifying the accuracy of the financial statements, including the balance sheet, income statement, cash flow statement, and equity statement.
2. **Internal Control Evaluation:** Auditors assess the strength and effectiveness of the internal control systems in place.

3. **Compliance Check:** Auditors ensure that the entity complies with the relevant laws, regulations, and standards applicable to the industry.
4. **Risk Assessment:** Auditors identify key financial risks and review how they are managed.
5. **Materiality:** The audit focuses on material transactions and events that could influence the users of the financial statements.

Objectives of Audit:

Primary Objective:

1. To express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
2. The auditor's report provides reasonable assurance to stakeholders that the financial statements are free from material misstatement due to errors or fraud.

Secondary Objectives:

1. **Detection and Prevention of Errors and Fraud:** Although auditors are not responsible for finding all fraud or errors, their procedures help identify significant issues.
2. **Compliance with Legal and Regulatory Requirements:** Auditors ensure that the organization adheres to all relevant laws and standards, such as taxation laws, company laws, and industry regulations.
3. **Improvement of Internal Controls:** By reviewing the internal control systems, auditors can suggest improvements to management, which can lead to better risk management and operational efficiency.
4. **Enhanced Credibility:** A clean audit report increases the confidence of investors, creditors, and other stakeholders in the financial health of the organization.

2. Basic Principles Governing an Audit and Concept of Auditor's Independence

Basic Principles Governing an Audit:

- a. **Integrity:** Auditors must be straightforward and honest in all professional relationships. They must adhere to ethical standards and maintain trustworthiness.
- b. **Objectivity:** Auditors must not allow bias, conflicts of interest, or undue influence from others to override their professional judgment.
- c. **Independence:** Auditors should be independent both in fact and appearance. This means they must not have any financial or personal relationships with the entity being audited that could influence their judgment.
- d. **Confidentiality:** Auditors must not disclose any confidential information obtained during the audit unless legally obligated to do so.
- e. **Competence:** Auditors must possess the necessary professional knowledge, skills, and expertise to perform an audit effectively. This includes staying updated with developments in auditing standards and industry specific regulations.
- f. **Professional Scepticism:** Auditors must maintain a questioning mindset, particularly when assessing areas of higher risk such as revenue recognition and fraud detection.
- g. **Due Care:** Auditors must apply diligence, thoroughness, and the highest standards of professional care during the audit process.

Concept of Auditor's Independence:

Definition: Auditor independence refers to the freedom from conditions that threaten the auditor's ability to form an unbiased and objective opinion on the financial statements.

Importance of Independence:

1. Ensures that the auditor's opinion is impartial and reliable.
2. Enhances the credibility of the financial statements, giving assurance to stakeholders that the statements are free from material misstatement.

Types of Independence:

1. **Independence in Fact:** The actual condition of being unbiased, without any personal, financial, or other conflicts that may influence the auditor's judgment.
2. **Independence in Appearance:** The perception by third parties that the auditor is independent. Even if the auditor is independent in fact, if there is a perception of bias, their opinion may be questioned.

Threats to Independence:

1. **Self Interest Threat:** When the auditor has a financial interest in the client (e.g., owning shares or having outstanding fees).
2. **Self-Review Threat:** When the auditor is auditing their own work (e.g., consulting services provided by the same firm that performs the audit).
3. **Advocacy Threat:** When the auditor promotes the client's position or opinion to the extent that their objectivity is compromised.
4. **Familiarity Threat:** When the auditor becomes too familiar with the client, often due to long term associations.
5. **Intimidation Threat:** When the auditor feels threatened by the client, such as by being pressured to issue a favorable report under the threat of losing the audit contract.

Safeguards:

1. Rotation of audit partners or firms.
2. Implementing firmwide policies that enforce independence.
3. Disclosure of relationships between the auditor and the client.
4. Adhering to professional and regulatory standards.

3. Errors and Fraud

Concepts of Errors and Fraud:

Errors:

Errors refer to unintentional misstatements in financial information. These can arise due to clerical mistakes, misinterpretation of accounting principles, or omission of important data.

Examples include data entry errors, inaccurate estimations, or oversight in recording transactions.

Fraud:

Fraud is an intentional act by one or more individuals among management, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Types of fraud include falsification of financial statements (financial statement fraud), misappropriation of assets (asset theft), and corruption (e.g., bribery).

Means of Committing Fraud:

- i. **Asset Misappropriation:** Stealing company assets, such as cash, inventory, or equipment.
- ii. **Financial Statement Fraud:** Deliberately inflating revenues, understating liabilities, or manipulating financial statements to meet financial targets.
- iii. **Corruption:** Involving kickbacks, bribery, or conflicts of interest where financial gains are illicitly secured.

Auditor's Responsibility Towards Detection and Prevention of Fraud:

Detection: While the primary purpose of an audit is not to detect fraud, auditors are expected to provide reasonable assurance that the financial statements are free of material misstatements due to fraud or errors. This requires a risk-based approach, focusing on areas of higher fraud risk.

SA 240 (Revised) requires auditors to assess the risk of fraud and to perform audit procedures designed to detect any fraud related misstatements. Auditors must also maintain professional scepticism throughout the audit process, especially in areas prone to manipulation such as revenue recognition.

Prevention: Auditors provide recommendations to management on improving internal controls to prevent fraud. Strong internal controls, proper segregation of duties, and a whistleblower system can help reduce fraud risks.

Difference Between Audit and Investigation:

Audit: A general examination of financial statements to provide an opinion on their fairness. The scope is broad, covering all material aspects of the financial statements.

Investigation: A specific examination into particular areas where there is suspicion of fraud or irregularities. Investigations are more detailed and focused than audits.

4. Classification of Audit

Based on Organization Structure:

Statutory Audit:

A mandatory audit required by law or regulations (e.g., companies are required by law to undergo statutory audits as per the Companies Act). The auditor provides an opinion on whether the financial statements comply with the relevant laws and accounting standards.

Non-Statutory Audit:

A voluntary audit not required by law. Organizations may opt for non-statutory audits to gain assurance on the financial health of the company or to improve internal controls.

Based on Objective:

Internal Audit:

Conducted by an internal auditor or a department within the organization. The main objective is to evaluate the effectiveness of internal controls, risk management, and governance processes. It is a continuous process, providing management with insights for improving operational efficiency and ensuring compliance with policies.

Independent Financial Audit:

Conducted by external auditors to express an independent opinion on the financial statements. It is focused on assessing whether the financial reports are free of material misstatement and comply with the applicable financial reporting framework.

Based on Periodicity:**Periodical Audit:**

Conducted at fixed intervals, typically annually. It reviews the complete set of financial statements to ensure their accuracy and fairness at the year end.

Continuous Audit:

A continuous audit is performed throughout the financial year. It is common in large organizations with complex transactions, where real time or frequent auditing is necessary to keep track of financial records.

Interim Audit:

Conducted partway through the financial year, usually before the final audit. The purpose is to review interim financial results and test internal controls before the yearend.

Final Audit:

The final audit is conducted after the close of the financial year. It reviews all transactions and financial records for the entire year to issue the final audit report.

Based on Technique:**Balance Sheet Audit:**

Focuses primarily on verifying the accuracy of assets and liabilities in the balance sheet, including cash, inventory, fixed assets, receivables, and payables.

Standard Audit:

Follows a standard set of audit procedures and guidelines. Auditors examine all key areas of financial reporting based on predefined checklists.

Systems Audit:

Evaluates the efficiency and security of internal control systems, especially in large organizations. Systems audits are crucial for identifying weaknesses in control processes, information systems, and operational workflows.

EDP Audit:

Electronic Data Processing (EDP) Audit focuses on reviewing the reliability, accuracy, and security of the entity's computer-based systems. With the increasing use of technology in financial reporting, this audit ensures that financial data processed electronically is accurate and secure.

5. Standards on Auditing (SA) – Concept and Purpose**Concept:**

Standards on Auditing (SAs) are guidelines issued by recognized professional bodies such as the Institute of Chartered Accountants of India (ICAI). These standards provide a framework for the audit process and ensure consistency, quality, and professionalism in the conduct of audits.

Purpose:

1. To ensure that auditors follow a systematic and consistent approach when conducting audits.
2. To enhance the reliability and credibility of the financial statements and the audit report.
3. To provide auditors with clear guidance on planning, executing, and reporting on audits, ensuring the audits are performed with competence and due care.

SA 200 (Revised):

1. This standard outlines the overall objectives of an independent auditor and the conduct of an audit in accordance with Standards on Auditing.
2. The auditor's objectives include obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error and reporting on the financial statements based on their findings.

SA 240 (Revised):

1. This standard focuses on the auditor's responsibilities relating to fraud in an audit of financial statements.
2. It emphasizes that auditors must maintain professional scepticism throughout the audit process and perform specific risk assessments to detect fraud. SA 240 also provides guidelines on how to communicate fraud findings to management or regulatory authorities if necessary.

