

# AAS - 1

## BASIC PRINCIPLES GOVERNING AN AUDIT

### OBJECTIVE

TO UNDERSTAND THE TERM 'AUDIT' AND TO DISCUSS THE PERSONAL QUALITIES AND PROFESSIONAL RESPONSIBILITIES OF AN AUDITOR.

#### 1.1 Introduction

Audit is a trust profession. The trust arises out of the reasons of auditor's integrity, objectivity, independence and the exhibition of his skills and competence in discharging his attest function. This AAS defines the term Audit and analyzes the fundamental trait requirements of an auditor to stand the test of trust possessed in him by the business, investors, lenders, government and the public in general.

#### 1.2 Audit

"Audit" is an independent examination of financial information of any entity,

- ❖ Whose activities are carried on with profit motive or not,
- ❖ Irrespective of its size or legal form,

Where such an examination is conducted with a view to express an opinion thereon.

Purpose:

*To express an opinion on the financial statements*

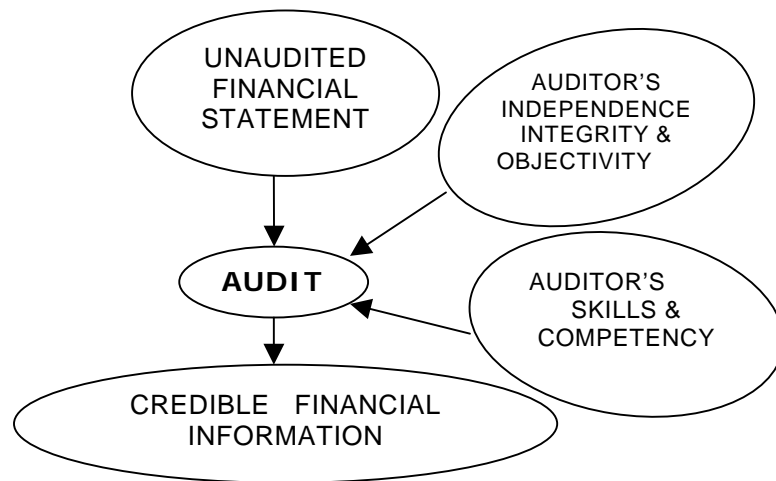
#### 1.3 Financial Information

The term 'financial information' includes Balance Sheet, Profit and Loss Account, Notes on Accounts and all other information, which are attached/annexed to the above. In simple terms it implies financial statements.

#### 1.4 Role of an auditor in the audit of financial information

The concept of separation of management from ownership fuelled the growth of this profession. The owners who could not participate in the day-to-day management of the enterprise wanted an assurance that the financial information prepared by the management is reliable. An audit provides such an assurance and enhances the credibility of the information. The role of audit can be depicted as follows.

*Auditor enhances reliability of financial information*



### 1.5 Personal Traits of an auditor

An auditor should possess

- ❖ Integrity,
- ❖ Objectivity and
- ❖ Independence

**1.5.1** Integrity implies an attitude of straightforwardness, honesty, sincerity, uprightness and reliability.

**1.5.2** Objectivity is a state of mind,

- ❖ Free from any influence
- ❖ Without Prejudice or bias

**1.5.3** Independence is again a state of mind. Auditor's independence can be analyzed from two perspectives

- ❖ Personal Independence and
- ❖ Professional Independence.

Personal independence means that the auditor's thinking and judgment will not be influenced by any other considerations and his uncompromising attitude in discharge of professional duties. Professional independence implies that the auditor, will not be influenced by the client or any body in terms of the methodology adopted in conducting an audit, the extent of his verification and the reporting requirements.

**1.5.4** Though Integrity, Independence & Objectivity are the fundamental value pillars of audit profession, it is not often recognized by the society. This is due to the fact that unlike judiciary wherein a system of higher authorized scrutiny was possible, chartered accountancy profession was not able to provide such a visible trail, though a well-structured disciplinary mechanism exists for regulation of the profession. Of course, the fundamental factors like existence of confidential relationship with the client, a strong emphasis to serve the management, the tendency of emerging limited number of large firms, tendency to market the profession are also the factors that affect the visibility of independence of the profession. Other factors potentially affect the auditor's independence and objectivity are:

- ❖ Provision of non audit related services by the chartered accountants wherein the fee charged is far higher than the fee received for audit related services
- ❖ Competition among the firms
- ❖ Size of the audit firm
- ❖ Speed of disciplinary proceedings
- ❖ Extent of auditor's liability to third parties (of course, in Indian context this is yet to happen)

## **1.6 Professional traits of an auditor**

- ❖ Confidentiality
- ❖ Skills and Competence

### **1.6.1 Confidentiality**

Auditor should not disclose the information acquired in the course of audit to any one, unless

- ❖ There is a legal or professional duty to do so
- ❖ Consented by the client.

*Information about client's business should not be disclosed*

A breach of this would be misconduct under Part I of the second schedule to the Chartered Accountants Act, 1949.

### **1.6.2 Skills And Competence**

Audit should be conducted by persons

- ❖ Who possess due professional care,
- ❖ Who are adequately trained
- ❖ With experience and competence.

*Persons with specialized skill and competence should conduct the Audit*

## 1.7 Work flow involved in an audit

The following is the broad outline of the workflow involved in conducting an audit

- ❖ Assessing the Accounting System And Internal Control
- ❖ Planning
- ❖ Work Performed By Others
- ❖ Audit Evidence
- ❖ Documentation
- ❖ Audit Conclusions And Reporting

### 1.7.1 Assessing the Accounting System And Internal Control

An auditor should assess the accounting system to ensure that the system is adequate to record all the accounting information. Evaluation of the Internal control apart from providing an assurance to the auditor that the transactions are carried out with proper authorization and within the policy of the organization, also allows him to determine the nature, timing and extent of his audit procedures.

*Helps the auditor in determining the nature, timing and extent of audit procedures*

### 1.7.2 Planning

Planning helps an auditor to conduct an audit in an effective, efficient and timely manner. Planning includes

- ❖ Acquiring knowledge about the client's business, the business environment in which the client operates
- ❖ Identify the events, transactions and practices, which in auditor's judgment may have an impact on the financial statements or his audit or his report.
- ❖ Gaining an understanding of the accounting system, policies and internal control procedures followed by the client
- ❖ Establishing the expected degree of reliance to be placed on internal control
- ❖ Determining the audit program, the nature, timing and extent of audit procedures to be performed
- ❖ Coordinating the work to be performed
- ❖ Revision of plan as and when required

*Helps the auditor in conducting the audit in an effective, efficient & timely manner*

### 1.7.3 Work Performed By Others

An auditor cannot do all the work by himself. The work is done either through his assistants or other professionals, but he continues to be responsible for forming and expressing an opinion on the financial statements. While delegating the work to others, he will be entitled to rely on the work performed by them, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In respect of work assigned to his assistants, he should carefully direct, supervise and review. In respect of work performed by other auditors, he should be reasonably assured that they are adequate for his purpose. In case of any independent statutory appointment to perform the work on which the auditor has to rely in issuance of his report, for example, in respect of branch audit of a company under section 228 of the Companies Act, 1956, the auditor's report should expressly state such a fact of his reliance on the work performed by other auditor.

*Should exercise due care in supervising the work of assistants*

### 1.7.4 Audit Evidence

An auditor should obtain sufficient (quantum) appropriate (relevance and reliable) audit evidence through the performance of compliance and substantive procedures. Compliance procedures are those which test the existence, effectiveness and continuity of the internal controls on which a reliance is placed by the auditor. Substantive procedures are those designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. This is done by:

*Audit Evidence- Obtained through compliance and substantive procedures*

- ❖ Test of details of transactions and balances and
- ❖ Analysis of significant ratios and trends including resulting inquiry of unusual fluctuations and items

### 1.7.5 Documentation

An auditor should document matters, which are important in providing evidence that the audit was conducted in accordance with the basic principles governing an audit. The auditor should maintain the documents for a reasonable period of time to meet the demands of his practice.

### 1.7.6 Audit Conclusions And Reporting

Auditor draws conclusions on the basis of

- a) Review and assessment of the audit evidence obtained; and
- b) His knowledge of the business, to form his opinion on the financial statements.

The review and assessment is directed towards whether

- ❖ The financial information prepared is based on acceptable accounting policies which are consistently applied,
- ❖ They comply with the relevant regulations and statutory requirements,
- ❖ Adequate disclosure of all material matters which are relevant for proper presentation

Audit report is the written expression of auditor's opinion on the financial information based on the scope of appointment and statutory requirements. If a statute prescribes the form and content of the audit report, for example Companies Act, 1956, audit report should adhere to such form and content requirements.

Auditor's opinion can be

- ❖ Unqualified,
- ❖ Qualified,
- ❖ Adverse or
- ❖ Disclaimer.

Unqualified opinion indicates auditor's satisfaction in all the three matters indicated above. Where a qualified, disclaimer or adverse opinion is issued, the audit report should state the reasons for it.

**Effective Date:** AAS 1 becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

## Review Questions

1. Define the terms "Audit", "Financial Information".
2. What is the role of an auditor in the audit of financial information?
3. What are the personal and professional qualities an auditor should possess? Briefly explain those qualities.
4. List down some of the factors that potentially affect the auditor's independence and objectivity
5. What is the work flow involved in an audit of financial information?
6. Explain why an auditor should assess an accounting system and internal control.
7. How should an auditor plan the audit?
8. What should an auditor do in respect of work performed by others?
9. Briefly explain the procedures that should be performed for obtaining audit evidence.
10. On what basis does an auditor draw his conclusions?
11. List down the four kinds of opinion an auditor can issue in an audit of financial information. Under what circumstance does an auditor issue unqualified opinion?

## Exam Questions & Hint answers

1. *What is the importance of having the accounts audited by independent professional auditors? (Q No. 3[a] May 01 PE II)*

**Ans :** The concept of separation of management from ownership fuelled the growth of audit profession. The owners who could not participate in the day-to-day management of the enterprise wanted an assurance that the financial information prepared by the management is reliable. An audit provides such an assurance and enhances the credibility of the information.

2. *State with reasons your views on the following 'An assistant of X & Co., Chartered Accountants wanted to verify the cash in hand and investments of T Ltd. The General manager (Finance) of T Ltd., suggested to the assistant of X & Co. that it was not necessary as his staff has done the same only few days back and no discrepancies were noted'. (Q.no 1[d]{compulsory} May 99 PE II)*

**Ans :** Independence is a state of mind. An Auditor should have both personal and professional independence. Professional independence implies that the auditor, will not be influenced by the client or any body in terms of the **methodology** adopted in conducting an audit, the extent of his verification and the reporting requirements. In this case it is open to X& Co, to decide the date, timing and the mode of physical verification of cash in order to obtain appropriate and satisfactory audit evidence in respect of

cash on hand and investments and T Ltd cannot prevent the auditor from devising the methods by which he wants to obtain sufficient appropriate audit evidence in this matter.

3. *'Auditor is entitled to rely on the work performed by others'. Comment. (Q.no 2[a]{compulsory} May 00 PE II)*

**Ans :** An auditor cannot do all the work by himself. The work is done either through his assistants or other professionals, but he continues to be responsible for forming and expressing an opinion on the financial statements. While delegating the work to others, he will be entitled to rely on the work performed by them, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In respect of work assigned to his assistants, he should carefully direct, supervise and review. In respect of work performed by other auditors, he should be reasonably assured that they are adequate for his purpose.

4. *Enumerate (in brief) the basic principles governing an audit (Q no 3[a] Nov 05 Final)*

5. *What are the basic principles governing an audit as laid down in AAS 1. Explain in brief. (Q no 3[a] Nov 06 PE II)*

**Ans :** Basic principles are:

- (i) Integrity, Objectivity and Independence: The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.
- (ii) Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
- (iii) Skills and Competence: The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.
- (iv) Work performed by others: When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. The

auditor should carefully direct, supervise and review work delegated to assistants.

- (v) Documentation: The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.
- (vi) Planning: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner
- (vii) Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information.
- (viii) Accounting System and Internal Control: The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.
- (ix) Audit conclusions and reporting: The 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.

6. *State briefly Audit Procedures and Audit Techniques (Q no 7[b] May 06 PE II)*

**Ans :** Audit procedures are broadly classified in two categories, viz., compliance procedures and substantive procedures. An auditor should obtain sufficient (quantum) appropriate (relevance and reliable) audit evidence through the performance of compliance and substantive procedures. Compliance procedures are those which test the existence, effectiveness and continuity of the internal controls on which a reliance is placed by the auditor. Substantive procedures are those designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. This is done by:

- Test of details of transactions and balances and
- Analysis of significant ratios and trends including resulting inquiry of unusual fluctuations and items

Audit techniques on the other hand refers to collection and accumulation of audit evidence. Some of the techniques commonly adopted by the auditors are the following:

- Posting checking
- Casting checking
- Physical examination and count
- Confirmation
- Inquiry
- Year-end scrutiny
- Re-computation
- Tracing in subsequent period
- Bank Reconciliation

The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

### Case Study

1. *ABC & Co are practicing chartered accountants with a billing of 1 Crore per annum. One of the clients, a group of companies, pays about Rs. 20 lacs as audit fees. Comment on the independence of ABC & Co, viz a viz this client?*

**Ans :** Though there is a no benchmark level to determine, that if a fee from a particular client is more than the specified level, it creates a situation of possible lack of independence due to over reliance on a particular client. However in this case 20% of the total fee is received from one single client or companies controlled by him, there is always a possibility of lack of independence, because loss of this client could affect the practice of ABC & Co, significantly. ABC & Co should strive to lower this dependence on a particular client over the shortest possible time.

2. *A & Co are the branch auditors of X Ltd. The statutory Auditors of the company, who is responsible for attesting the financial statements, request A & Co, to provide access or copy of his working papers. X Ltd also urges A & Co, to co-operate with the statutory auditor? Advice A & Co*

**Ans :** A & Co, if it wishes may provide extract of its working papers, to X Ltd, its client. To others, it is under no obligation to provide the copies or extract of his working papers.

3. *CARO 03 and Tax Audit reports require disclosure of certain violations. Is it possible for an auditor to take shelter under the confidentiality clause and not report the same?*

**Ans :** An auditor should not disclose the information acquired in the course of an audit, unless he is duty bound by law or where the client consents to such a disclosure. In this case, both CARO 03 and Tax Audit, demands certain disclosures, which are statutory provisions. Hence an auditor cannot take shelter under confidentiality clause.

