A Critical Review of the Definition of Audit with Special Reference to AAS 1 (SA 200)

Renu Gupta
Assistant Professor, Department of Commerce, SGGSCC, University of Delhi. renuguptadu@gmail.com

Abstract

The word “audit” has been derived from Latin word “audire” which means “to hear”. In earlier times, an auditor was appointed when accounts were suspected of some fraud. In 1494, an Italian, Luca Pacialo mentioned and described the duties and responsibilities of an auditor for the first time in his thesis, “Double Entry System of Book-Keeping”. Since then, lot of changes have occurred in the scope and definition of audit and duties and responsibilities of an auditor. Traditionally, audit was considered to be the test function of the financial transactions only and as aforesaid, an auditor was called when some error or fraud was suspected. But contemporary audit is not limited to checking of financial statements rather it extends to the review of systems, operations, performances and other such areas. And it has also become compulsory and a legal requirement in most of the cases that audit is needed to be conducted independently of the client. Definitions of audit given by different authors in the world at large reveals the limited scope of auditing which is no more relevant in today's circumstances. Institute of Chartered Accountants of India (ICAI) has also defined the term “audit” in its publication of Statements on Auditing and Assurance Standards: Basic Principles Governing an Audit (AAS 1 or SA 200). An attempt has been made in this paper to judge the relevance and significance of the definition of audit given by Auditing and Assurance Standards Board (AASB) of ICAI in AAS 1 in present context with the help of primary information collected through a questionnaire sent to 200 members of Institute of Chartered Accountants of India.

Key Words: Scope of Auditing, Audit as per AAS 1(SA 200), Non-Financial Information and Independent Examination.

Introduction

Evolution of audit is the result of industrial revolution that took place in eighteenth century as it became difficult for sole proprietors to manage business affairs on their own. And scattering of shareholders of joint stock companies in far off places made them realize the need of an individual who could check on their behalf how their investments were being utilized by the directors. In early stages of introduction of audit, the scope of audit was limited to checking whether accounting party has properly accounted for the receipts and payments of cash. Moreover, an auditor was appointed only when some error and fraud was suspected.

In modern time, audit has become mandatory rather than optional for most of the business firms
especially for joint stock companies and other institutions registered under specific enactments. Furthermore, now scope of audit is not restricted to test function of financial statements only, it extends to review of systems, operations, performances and other such areas. Moreover, today’s auditor is required to work independently of the client or management of the entity as he is generally appointed by shareholders for whom he conducts the audit and communicates the result through an auditor’s report.

Structure of the Paper

The present paper has been laid out into five Sections. Research methodology is given in Section I. Section II deals with literature survey. Section III depicts scope of auditing. Section IV presents empirical findings with regard to definition of audit in accordance with AAS 1 (SA 200). Conclusion and recommendations are stated in Section V.

I Research Methodology

This paper is based upon the study titled “Perceptions of Auditors on Various Aspects of Statutory Audit” carried out with the help of structured questionnaire. Questionnaire was sent to two-hundred members of Institute of Chartered Accountants of India (ICAI) in all. Out of two-hundred questionnaires, one hundred and sixty-eight questionnaires are returned and three questionnaires have not been included in the analysis because of incomplete responses. Thus, analysis has been made on the basis of views of one hundred and sixty-five participant auditors that constitute 82.5 percent response.

The study considers responses of chartered accountants who are practicing auditors only or may have experience of both auditing profession and industry. All of the respondents are experienced in statutory audit along with other forms of audit. They belong to different age groups and have audited several forms of organizations.

Information has been collected personally, through internet and by post. Analysis of the responses has been made on the basis of simple aggregative and percentages with the help of Microsoft excel worksheet.

II Literature Survey

Some studies have been carried out in relation to audit. A few of them contribute to corporate governance issues signifying importance of independent examination in an audit function. Research work is also done with regard to internal audit and internal control indicating application of non-financial information in audit task. Even case studies are developed to make audit students understand the value of non-financial information. Furthermore, independence of auditor in terms of audit fees or non-audit fees has also been attempted to be judged.

Wright, Krishnamoorthy and Cohen (2002) conducted a study to analyse whether auditors are sufficiently sensitive to the type and strength of corporate governance when conducting an audit. The purpose of the study was to examine how the type of the board (agency) impacts auditor’s judgments relating to audit programme planning. The findings indicated that the auditors respond to type and strength of board when making decisions with respect to audit programme planning. Auditors not only increase planned audit effort when the board is assessed as weak but also decrease audit effort when the board is assessed as strong.

Agrawal and Chadha (2004) examined whether certain governance mechanisms are related to the incidence of an earnings restatement by a firm. Furthermore, the corporate governance issues: independence of the board, audit
committee, use of an independent financial expert on the board or audit committee, use of independent director with large blockholdings on the board or audit committee, conflicts facing outside auditors, and the CEO’s influence on the board are also analysed. It was found that several key governance characteristics are essentially unrelated to the probability of a company restating earnings. These include the independence of boards and audit committees and the extent to which outside auditors provide non-audit services to a firm. It was also discovered that the probability of restatement is significantly lower in companies whose boards or audit committees include an independent financial expert; it is higher in companies whose CEO belongs to founding family.

Ghosh and Kallapur (2004) investigated investor perceptions proxied by earning response coefficients (ERCs), of auditor independence-in-appearance as a function of audit and non-audit fees. It was found that in separate regressions ERCs were negatively associated with the ratio of non-audit to total fees (non-audit fee ratio) and with client importance (auditor’s fees from a given client divided by auditor’s total revenues). When both were included in the same regression, however, only client importance remained significantly associated with ERCs.

Desai (2006) advanced research in internal audit (IA) evaluation by developing an IA assessment model that considers interrelationship among specific factors used by external auditors when evaluating the strength of the IA function. The model is built on three factors: competence, work performance and objectivity. The analysis revealed that modeling the relationship is essential for assessing the strength of the IA function. When the three factors have a strong or perfect relationship, the strength of the IA function remained high even if positive or negative evidence are there about the one of the factors. This result holds as long as there are high levels of beliefs about the other two factors.

Hoitash and Hoitash (2007) provide a detailed examination of the association of audit fees with internal control problems disclosed by public companies under provisions of Sarbanes-Oxley Act which made disclosure of internal control problems mandatory. This study suggests that companies disclosing these problems require the expenditure of greater audit engagement effort, and/or that they lead to application of risk premia to compensate the auditor for residual risk. Audit pricing of companies with internal control problems varies with problem severity, when severity is measured either as material weaknesses vs. significant deficiencies, or by nature of the problem.

Krishnamoorthy, Cohen and Wright (2008) developed a case in order to alert students to the importance of non-financial information in audit process; to develop students ability to search for relevant financial and non-financial information in audit planning process; and to emphasise the importance of maintaining professional skepticism and to resist the natural tendency to over-rely financial information when conducting the financial statement audit. The case is suitable for use in undergraduate and graduate auditing courses. The case presents a situation where the financial results of a company appear to present relatively low audit risk, while non-financial information yields a different conclusion. The case was developed and tested in both undergraduate and graduate classes and proved to be successful in achieving its objectives.

Aurelia (2008) stated that internal audit concept is not tridimensional irrespective of property forming the capital bears, the entity organisation, and the operating system-private-public-banking. Its goal is unique: to ensure the...
degree of control upon the operations for the entity, to guide the entity in order to improve its operations and to contribute to the adding of a plusvalue.

Hence, few studies have been undertaken on audit and auditing practices. More and more work is required to be done in this area especially in our country. There is wide scope of research as the term “audit” is very vast in terms of audit process, different branches of audit and other various aspects such as applicability of auditing standards and statutory regulations enforced by distinct authorities in this field. An attempt has been made in this paper to specify the importance of non-financial information and independent examination when conducting an audit with the help of critical examination of definition of audit.

III Scope of Auditing

In early stages of introduction of audit, the scope of audit was limited to checking whether accounting party has properly accounted for the receipts and payments of cash. In other words, auditing was done to know whether cash has been embezzled and if so, who embezzled it and by what amount. Thus, it was an audit of only cash book. But the objective of modern audit is to see whether balance sheet exhibits a true and fair view of the state of affairs of a company and has been drawn in accordance with the provisions of company’s act. Detection of fraud has become an incidental objective of audit in modern time (AAS 2 or SA 200A). Furthermore, checking efficacy of internal control system of an entity, evaluating performances and efficiency in operations and rendering advisory services are some of the other important aspects of auditing these days.

Spicer and Pegler have defined auditing as "such an examination of books, accounts, vouchers of a business, as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, to give a true and fair view of state of affairs of a business and whether profit and loss account give a true and fair view of profit and loss for the financial period, according to the best of his information and explanation given to him, and as shown by books and if not, in what respect he is not satisfied."

According to F.R.M. De. Paula, an English authority on auditing literature describes auditing as “The examination of a balance sheet and profit and loss account prepared by others together with the books, accounts and vouchers relating there to in such a manner that auditor may be able to satisfy himself and honestly report that, in his opinion, such a balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern, according to the information and explanation given to him and as shown by the books.”

J.R. Batliboi, a famous authority in accounting and auditing defines auditing as “An intelligent and a critical scrutiny of books of account of a business with vouchers and documents from which they are written up, for the purpose of ascertaining whether the working results for a particular period, as shown by the profit and loss account, as also the exact financial condition of that business, as reflected in the balance sheet are truly determined and presented by those responsible for their compilation.”

Institute of Chartered Accountants of India defines audit in AAS 1 or SA 200 (Basic Principles Governing an Audit) as “The independent examination of financial information of any entity, whether profit oriented or not and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.”

Montgomery, a leading American accountant, defines:” Auditing is a systematic
examination of books or records of a business or other organization, in order to ascertain or verify, and to report upon the facts regarding its financial position and results thereof.”

Thus, views are similar as all definitions reflect various aspects of one single dimension of auditing that it is a test function of financial statements. But the scope of contemporary auditing is extended to various realms. Auditing is not concerned with review of financial data alone. It extends to review of systems, operations of any entity and other such areas.

In this connection, description of auditing given by ICAI in its general guidelines on internal auditing (1983) presents widened scope of auditing. It defines auditing as: “A systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an entity for a stated purpose.” In any auditing situation, auditor perceives and recognizes the propositions before him for examination, collect evidence, evaluate the same and on this basis formulates his judgment which is communicated through his audit report.”

Hence, scope of auditing is extended to review of operations and performances connected with non-financial areas also. The purpose of auditing need not necessarily is expression of opinion about quality of financial statements alone; it may be for some stated purpose like giving some expert advice for improving efficiency, productivity of an entity or systemizing the operations. Moreover, even if the auditor is only engaged to comment upon the state of financial affairs of an enterprise, he is required to take help of non-financial aspects such as system of internal control and internal check existing in the entity to do justice with his job.

Therefore, role of non-financial information while performing an audit can never be neglected. In accordance with examples provided in SAS 56 (AICPA, 1988), non-financial information is defined as information that is not directly derived from financial statements, such as general economic conditions, technological changes in the client’s industry, and new products from competitors. Discussion can be concluded with the saying, “Conducting audit without integrating non-financial information is like playing cricket without wickets.” Saying meant that if you focus too strongly on financial information only, you risk missing a material misstatement in the client’s financial statements.

IV Findings: Audit as per AAS 1 (SA 200)

The Institute of Chartered Accountants of India in its publication of Statements on Auditing and Assurance Standards: Basic Principles Governing an Audit (AAS 1 or SA 200) describes audit as “The independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.” Opinions of respondents have been tested on the basis of this definition given in AAS 1 (SA 200) by ICAI in terms of their satisfaction level with reasons and adjustments if any. Responses have been summarised and analysed with the help of Table 1 as follows:

Table 1
Definition of Audit as per AAS 1 (SA 200)

<table>
<thead>
<tr>
<th>Responses</th>
<th>Number of Respondents</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Yes</td>
<td>129</td>
<td>78.18</td>
</tr>
<tr>
<td>2. Can't Say</td>
<td>14</td>
<td>8.49</td>
</tr>
<tr>
<td>3. No</td>
<td>22</td>
<td>13.33</td>
</tr>
<tr>
<td>Total</td>
<td>165</td>
<td>100.00</td>
</tr>
</tbody>
</table>
Table 1 depicts that nearly, four-fifths (78.18 percent) of the respondents are satisfied with the aforesaid definition of audit. Following reasons are rendered by them as found in their responses in support of their consent with the definition of audit as per AAS 1 (SA 200):

1. Audit means to examine all the records of the company so as to give true and fair picture whether it is related to profit or not.
2. Without independence, no proper audit can be performed.
3. The object of an audit is to assure and express an opinion that financial statements are properly stated and free from material misstatements.
4. It is comprehensive yet brief description.
5. Definition as per AAS 1 is correct as audit is to express an independent opinion about the financial information.
6. Here, financial information encumbrance’s financial statements so as to include office financial statement items as well. It is the duty of auditor to maintain, integrity, objectivity and independence while conducting the audit.
7. Auditor is a watch dog and not a blood hound.
8. Audit is conducted by a qualified person who is not an employee of the entity and he examines various aspects of the financial information given to him by the entity and he expresses his independent opinion on that.
9. Audit whether regular or statutory, primarily deals with financial information and not with proprietary details.
10. It covers all types of organisations whether profit oriented or not and hence, it covers trusts etc.

Thus, most of participants are satisfied with the definition of audit as per AAS 1 due to one reason or another covering each and every aspect of it. On the other hand, more than one-fifth (21.82 percent) of the participants are either unsatisfied or are in state of indecisiveness with regard to audit defined as per AAS 1 (SA 200). Not more than even one-eighth (13.33 percent) of the participants have shown discontentment with the definition for following reasons as found in their responses:

1. The definition is needed to be adjusted as audit is independent examination of financial information and internal control to certain extent of any entity.
2. Definition speaks only about financial audit although audit is a wider term. Accordingly, it is a definition of “financial audit” but not of “audit”.
3. “Our appointment should not be assigned by the company in which we are doing audit.” Moreover, fee for audit should also not be paid by the client as it affects the independence of the auditor.
4. Now a days, in this commercial world, auditors have lost their independence. Nobody wants to loose their client, they have to find midway to retain the client and remain with the law.
5. Audit includes examination of financial as well as non-financial information.
6. Internal audit is an independent objective, assurance activity designed to add value and improve organizational operations. It is not limited to examination of only financial information.
7. The scope of audit is not limited to financial information but extends to non-financial information also as marketing audit, efficiency audit, social audit, environmental audit and personal audit.
8. Major share of assesses is in unorganized sector where independence of auditor hardly exists.

9. In most of the cases, independence of the auditor does not exist.

Hence, discontentment amongst the auditors with regard to definition of audit as per AAS 1 (SA 200) is because of two reasons mainly: (i) examination of non-financial information has not been given place in it and (ii) independent examination has lost its significance in present time.

V Conclusion and Recommendations

In general, the term audit implies “audit of financial statements” in which auditor expresses his expert opinion about the quality of such statements or he merely attests the truth of the statements. On the other hand, in its widest scope, the term audit implies audit of non-financial matters as well like audit of operations, efficiency, performances and others. Moreover, definition of audit as per AAS 1 or SA 200 has also not been found unanimously satisfactory as it does not include scrutiny of non-financial information and independent examination is becoming difficult these days.

Therefore, definition of audit as per AAS 1 (SA 200) was subject to reconsideration by ICAI in light of the present widened scope of audit. Furthermore, effective steps were inevitable to check the significance of the words “independent examination” in the definition. Instead, the aforesaid definition of audit has been withdrawn from the SA 200 (Revised) and use of the words “audit of financial statements” has been made to specify the limited scope of statutory audit. Hence, there is no place for “non-financial information” in SA 200 (Revised) also; though dealing with non-financial information for an auditor becomes very important sometimes even in case of a financial audit. However, attempts have been made to specify the meaning of the term “independent auditor” who is subject to fulfill relevant ethical requirements, including those pertaining to independence which comprise code of ethics issued by ICAI for the independent auditor based on the fundamental principles of integrity, objectivity, professional competence and due care and professional behaviour. Moreover, the code requires the auditor to be independent of the entity in terms of both independence by mind and independence in appearance.

Thus, meaning of the words “independent auditor” or “independence” has been expounded in golden words but no effective steps have been taken to make the auditors independent of the entity in real sense. However, statements have been made, i.e., Standards on Quality Control (SQC) 1 sets out the responsibility of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirement, including those pertaining to independence and so on. Thereby, no effective treatment is being done even after identifying the seriousness of the disease. Though, Satyam saga would be still fresh in the minds of the standards setters. Is the only objective of revising the existing standards to make them compatible with international norms?

It is, of course, essential that an auditor preserve his objectivity and integrity from his own viewpoint, commonly called “independence in fact”, it is also important that auditor appear independent to all users of the information he provides. This latter concept is key ingredient to the value of audit function, since users of audit reports must be able to rely on the independent auditor. The objective of the independent
examination can only be achieved by making the auditor independent of the entity and that will only become possible by improving the prevailing appointment and remuneration procedure of the auditors. Thus, Following are some of the possible measures that can be taken in this respect:

- Appointment procedure of auditors should be adopted that can facilitate better independence. For example, such an independent private agency can be established by government that makes the appointments of auditors itself on behalf of entities in various organisations where audit is a legal requirement. Standards may also be required to be prescribed in such appointment.

- Remuneration of statutory auditors should also be fixed by an independent private agency created by government and payment should be made in such a manner that enterprise is involved indirectly only. It would help in preventing any possibility of collusion between client and auditor.

- Efforts should be made to check the assesses in unorganized sector.

- Liabilities of auditors who do not present a fair and true picture must be made more stringent.

Further research should be directed at showing the objections of those who wanted the definition to be revised to those who were satisfied and the responses of the latter respondents must be sought especially in the light of current changes made in form of SA 200 (Revised) in this respect.

References

10. Wright Arnie, Krishnamoorthy Ganesh & Cohen Jefffrey (2002), Corporate Governance and Auditors’ Program
1 Auditing Assurance Standards (AAS) have been reclassified and renamed as Standards on Auditing (SA) with effect from 1st April, 2008 as per Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services. Accordingly, AAS 1 has become SA 200.

2 AAS 2 (SA 200 A) “Objectives and Scope of the Audit of Financial Statements” has been revised entirely and has been included in SA 200 (Revised) in accordance with which the overall objective of an independent auditor involves getting reasonable assurance whether financial statements are free of material misstatements whether due to error or fraud so that the auditor is able to express an opinion on the quality of financial statements and report his findings in accordance with SAs.

3 SA 200 (Revised) “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing” has now been introduced by ICAI replacing SA 200 along with SA 200 A entirely effective from 1 April, 2010; from which the aforesaid definition has been withdrawn leaving the problem unsolved and hence, issues raised in the present paper are burning yet.