Financial Audit

The purpose of an audit of financial statements is to enhance the degree of confidence of intended users in the financial statements. This is achieved through the expression of an opinion by the auditor as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, or – in the case of financial statements prepared in accordance with a fair presentation financial reporting framework – whether the financial statements are presented fairly, in all material respects, or give a true and fair view, in accordance with that framework.

3.2.1 In conducting an audit of financial statements, the overall objectives of the auditor 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 the result of the audit in accordance with the auditor's findings.

The objectives of financial audit in public sector are often broader than expressing an opinion on the financial statements. The audit mandate arising from legislations, regulation and government policy requirements may result in additional objectives.

3.2.2 Financial Reporting Frameworks

Financial reporting frameworks may be for general or specific use. A framework designed to meet the information needs of a wide range of users is referred to as a general-purpose framework, while special-purpose frameworks are designed to meet the specific needs of a specific user or group of users.

a) General Purpose frameworks:

The International Public Sector Accounting Standards (IPSASs), International Financial Reporting Standards (IFRSs), the Indian Accounting Standards, or other national financial reporting frameworks for use in public sector constitute general purpose frameworks. A complete set of financial statements for a public sector entity prepared in accordance with such a financial reporting framework, normally consists of:

1. a statement of financial position;
2. a statement of financial performance;
3. a statement of changes in net assets/equity;
4. a cash flow statement;
5. a comparison of budget and actual amounts – either as a separate additional financial statement or as a reconciliation;
6. notes, comprising a summary of significant accounting policies and other explanatory information.
7. In certain environments a complete set of financial statements may also include other reports, such as reports on performance and appropriation reports.

If the financial statements are prepared in accordance with a framework for other accounting bases, such as modified accrual or cash basis (e.g. Indian Government Accounting Standards – IGAS), a complete set of financial statements may not include all of the above.

b) Special-Purpose Frameworks:

In addition to preparing general-purpose financial statements, a public sector entity may prepare financial statements for other parties (such as governing bodies, the legislature or other parties with an oversight function), which may require financial statements tailored to meet their specific information needs. In some environments financial statements of this kind are the only financial statements prepared by the public sector entity. Special-purpose frameworks relevant to the public sector may include:

1. the cash receipts and disbursements, basis of accounting for cash flow information that an entity may be required to prepare for a governing body;
2. the financial reporting provisions established by an international funding organization or mechanism;
3. the financial reporting provisions established by a governing body, the legislature or other parties that perform an oversight function to meet the requirements of that body; or
4. the financial reporting provisions of a contract, such as a project grant.

c) Frameworks prescribed by law or regulation:

Frameworks prescribed by law or regulation will often be deemed acceptable by the auditor. Such frameworks invariably require presentation of original and final budget amounts and actual amounts on a comparable basis to complete the accountability cycle by enabling users of financial statements to identify whether the resources were obtained and used in accordance with the approved budget.

The accounting base, basis of classification, the level of aggregation of budget heads for presentation in financial statements are determined by law, rules and regulations. Such financial reporting frameworks are thus invariably governed by standards, which are rule based and could be different from the principles envisaged in general purpose frameworks. The Government Accounting Rules, 1990, General Financial Rules, 2005, Delegation of Financial Powers Rules, 1978 and List of Major and Minor Heads, Annual Appropriation Acts,Finance and Accounts Codes and rules that govern preparation and compilation of finance and appropriation accounts of the Union and the States constitute the rule based standards. These auditing standards would apply to audits of such frameworks with appropriate modifications.

3.2.3 Materiality

The auditor shall apply the concept of materiality in an appropriate manner when planning and performing the audit.

A misstatement is material, individually or when aggregated with other misstatements, if it could reasonably be expected to influence the decisions taken by users on the basis of the financial statements. When planning the audit strategy, the auditor shall assess materiality for the financial statements as a whole. However, where one or more classes of transactions, account balances or disclosures could reasonably be expected to influence the decisions of users on the basis of the financial statements, the auditor shall also determine the materiality level or levels for the classes of transactions, account balances or disclosures concerned.

3.2.4 Audit risk

The audit risk in an audit of financial statements is the risk that the auditor will express an inappropriate conclusion if the subject matter information is materially misstated.

The auditor will reduce the risk to an acceptably low level in the circumstances of the audit to obtain reasonable assurance as the basis for expressing a conclusion in a positive form. In general, the audit risk depends on the inherent risk and control risk, which constitute the risks of material misstatement and the detection risk:

a) Inherent risk – the susceptibility of the subject matter information to material misstatement, assuming that there are no related controls;

b) Control risk – the risk that a material misstatement could occur and will not be prevented or detected and corrected at the appropriate time by related controls. Some control risk will always exist due to the limitations inherent in the design and operation of internal controls.

c) Detection risk – the risk that the auditor will not detect a material misstatement.

The risk assessment is a matter of professional judgement and is not capable of precise measurement. The degree to which the auditor considers each element of risk will depend on the circumstances of each audit.

3.2.5 Risk Assessment

The auditor shall assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances and disclosures so as to provide a basis for designing and performing further audit procedures.

For this purpose, the auditor needs to:

1. identify risks throughout the process of obtaining an understanding of the entity being audited and its environment, by examining relevant controls that relate to the risks and considering the classes of transactions, account balances and disclosures in the financial statements;
2. assess the risks identified and evaluate whether they relate more pervasively to the financial statements as a whole and could potentially affect many assertions;
3. relate the risks identified to what could go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
4. consider the likelihood of misstatement, including the possibility of multiple misstatements, whether the potential for misstatement is such as to render it material.

As part of the risk assessment, the auditor determines whether any of the risks identified is, in the auditor's judgment, significant. When judging which risks are significant, the auditor needs to consider at least the following:

1. risk of fraud;

2. recent significant economic, accounting or other developments, which requires specific attention;
3. the complexity of transactions;
4. significant transactions with related parties;
5. the degree of subjectivity in the measurement of financial information related to the risk, especially measurements which involve a wide range of measurement uncertainty;
6. significant transactions that are outside the entity's normal course of business, or that otherwise appear to be unusual; and
7. compliance with laws and regulations.

The auditor shall act appropriately to address the assessed risks of material misstatement in the financial statements. Responses to assessed risks include designing audit procedures that address the risks, such as substantive procedures and test of controls. Substantive procedures include both tests of details and substantive analysis of classes of transactions, account balances and disclosures.

3.2.6 Going Concern Considerations

The auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Financial statements are normally prepared on the assumption that the entity is a going concern and will continue to meet its statutory obligations for the foreseeable future. In assessing whether the going-concern assumption is appropriate, those responsible for preparation of the financial statements take into account all available information for the foreseeable future. General-purpose financial statements are typically prepared on a going-concern basis.

The going-concern concept may have little or no relevance for public-sector entities such as those funded through appropriations on the public sector budget. When such organizations are abolished or merged with others, their liabilities and assets are usually taken over by other public-sector entities. For some other types of entities, such as public sector business enterprises and joint ventures with other principals (including private sector entities operating in legal forms that provide for limited owner liability), this may not be the case. The responsibility for implementing public sector programmes may also be contracted out to private sector organizations, such as NGOs and private companies, but the programmes may still be audited by SAI, India, making the going-concern concept and the auditor's judgement in this regard relevant to public-sector financial audit.

3.2.7 Considerations Relating to Fraud in an Audit of Financial Statements

The auditor shall identify and assess the risks of material misstatement in the financial statements due to fraud, shall obtain sufficient and appropriate audit evidence regarding the assessed risks of material misstatement due to fraud and shall respond appropriately to fraud or suspected fraud identified during the audit.

The auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor is whether the action resulting in a misstatement was intentional or unintentional. Fraud is a broad legal concept and the auditor does not make legal determination of fraud. The auditor is concerned only with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor - misstatements resulting from fraudulent financial reporting and those resulting from the misappropriation of assets.

Areas in which auditors shall be alert to fraud risks leading to material misstatement may include procurement, grants, privatisations, intentional misrepresentation of results or information and misuse of authority or power. Auditors shall also consider that the use of public monies tends to raise the profile of fraud. As a result auditors may need to be responsive to public expectations regarding fraud detection.

3.2.8 Considerations Relating to Laws and Regulations in an Audit of Financial Statements

The auditor shall identify the risks of material misstatement due to direct and material non-compliance with laws and regulations.

The auditor shall obtain sufficient and appropriate audit evidence regarding compliance with the laws and regulations such as the Appropriation Acts (which prescribe budgetary allocations against which expenditures are incurred and are subject to audit) that are generally recognised to have a direct and material effect on the determination of material amounts and disclosures in financial statements. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect all breaches of laws and regulations.

The effect of laws and regulations on the financial statements varies considerably. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the nature of reported amounts and disclosures while other laws or regulations, which are to be complied with by management, may not have a direct effect on the entity’s financial statements. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the audited entity that may have a material effect on the financial statements. Matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit shall be communicated to management/those charged with governance, save where the matters are clearly inconsequential.

3.2.9 Consideration of Subsequent Events

The auditor shall obtain sufficient and appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require an adjustment to, or disclosure in, the financial statements have been identified.

Financial statements may be affected by certain types of subsequent events (those occurring after the date of the financial statements). Many financial reporting frameworks specifically refer to such events. Ordinarily, two types of events are identified:

1. Events that provide evidence of conditions that existed at the date of the financial statements; and
2. Events that provide evidence of conditions that arose after the date of the financial statements.

Procedures shall be designed, as nearly as possible, to cover the period from the date of the financial statements to the date of the auditor's report. The auditor is not, however, expected to perform additional audit procedures on matters to which previous audit procedures have provided satisfactory conclusions. Procedures for obtaining sufficient and appropriate audit evidence may include:

1. steps to obtain an understanding of any procedures established by management to ensure that subsequent events are identified;
2. inquiries of management;
3. scrutiny of minutes of the Board / those charged with governance;
4. scrutiny of the entity's most recent interim financial statements, if any
5. written confirmation from the management /those charged with governance.

The auditor is under no obligation to perform any audit procedures on the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the financial statements have been issued, a fact becomes known to the auditor that, had it been known at the date of the auditor's report, might have caused an amendment to the report, appropriate action shall be taken. Such action may include:

1. discussing the matter with the management and, where appropriate, those charged with governance,
2. determining whether the financial statements need amendment and, if so,
3. inquiring how the management intends to address the matter in the financial statements.
4. obtaining written confirmation from the management.

If the management does not take the necessary steps and does not amend the financial statements, the auditor shall notify the management and those charged with governance that the auditor will seek to prevent future reliance on the auditor's report. This may entail seeking legal advice and reporting to the appropriate statutory body.

3.2.10 Evaluating Misstatements

Uncorrected misstatements shall be evaluated for materiality, individually or in aggregate, to determine their effect on the opinion to be given in the auditor's report.

The auditor needs to determine whether uncorrected misstatements are material, individually or in the aggregate. To this end, the auditor shall consider

1. the size and nature of the misstatements, in relation both to particular classes of transactions, account balances or disclosures and to the financial statements as a whole, and the particular circumstances of their occurrence; and
2. the effect of uncorrected misstatements from prior periods on the relevant classes of transactions, account balances or disclosures, and on the financial statements as a whole.

The auditor shall invite the management to correct misstatements, and if the management refuses to correct some or all communicated misstatements the auditor shall ascertain the reasons. When evaluating whether the financial statements as a whole are misstated, the auditor shall consider the reasons given for not making corrections. Those charged with governance shall be notified of uncorrected misstatements and the effect that they may have, individually or in aggregate, on the opinion in the auditor's report. The auditor’s notification shall individually identify uncorrected material misstatements in classes of transactions, account balances or disclosures. Misstatements that are clearly trivial need not normally be communicated, save where the auditor is required by mandate to report all misstatements.

3.2.11 Forming an Opinion and Reporting on the Financial Statements

The auditor shall form an opinion based on an evaluation of the conclusions drawn from the audit evidence obtained, as to whether the financial statements as a whole are prepared in accordance with the applicable financial reporting framework. The opinion shall be expressed clearly in a written report that also describes the basis for the opinion.

In order to form an opinion, the auditor must first conclude whether reasonable assurance has been obtained as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. The conclusion shall take into account:

1. Whether sufficient and appropriate evidence has been obtained;
2. Whether uncorrected misstatements are material, individually or in aggregate; and
3. The auditor’s evaluations of the financial statements.

The auditor shall express an unmodified opinion if it is concluded that the financial statements are prepared, in all material respects, in accordance with the applicable financial framework. If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement, or is unable to obtain sufficient and appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor’s report. Auditors may provide three types of modified opinions: a qualified opinion, an adverse opinion and a disclaimer of opinion as envisaged in para 2.5.2.3 of Chapter 2.

The decision regarding which type of modified opinion is appropriate depends upon:

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with the management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, determine whether it is necessary to modify the audit opinion.

The expression of opinion in the Auditor’s Report shall use one of the following equivalent phrases when expressing an unmodified opinion on the financial statements prepared in accordance with a fair presentation framework:

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor’s opinion shall be that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. When expressing a modified opinion, the auditor shall also modify the heading to correspond with the type of opinion expressed.

Apart from the section that contains the Opinion, Auditor’s Report may include separate sections on a) responsibility of Management for the financial statements, stating that the management is responsible for the financial statements in accordance with the applicable financial reporting framework, b) responsibility of Auditors, stating that the responsibility of the auditor is to express an opinion based on the audit of the financial statements and describing the scope of audit and audit procedures carried out, c) Emphasis of Matter and Other Matters paragraphs and d) other regulatory and reporting responsibilities of auditors.

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that is of such importance that it is fundamental to their understanding of the financial statements, but there is sufficient and appropriate evidence that the matter is not materially misstated in the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report. Emphasis of Matter paragraphs shall only refer to information presented or disclosed in the financial statements.

If the auditor considers it necessary to communicate a matter, other than those that are presented or disclosed in the financial statements, which, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, and provided this is not prohibited by law or regulation, this shall be done in a paragraph with the heading "Other Matter," or another appropriate heading. This paragraph shall appear immediately after the opinion and any Emphasis of Matter paragraph.

1. Form of Opinion
2. Determining the type of modification to the auditor's opinion -
    1. The nature of the matter giving rise to the modification – that is, whether the financial statements are materially misstated or, in the event that it was impossible to obtain sufficient and appropriate audit evidence, may be materially misstated; and
    2. The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.
3. Expression of opinion in the Auditor's Report -
    1. The financial statements present fairly, in all material respects... in accordance with [the applicable reporting framework]; or
    2. The financial statements give a true and fair view of ... in accordance with [the applicable financial reporting framework]
4. Emphasis of Matter and Other Matters Paragraphs in the Auditor's Report

3.2.12 Comparative information – 'Corresponding figures and comparative financial statements Comparative information' refers to amounts and disclosures included in the financial statements in respect of one or more prior periods. The auditor shall evaluate whether:

1. **the comparative information agrees with the amounts and other disclosures that were presented in the prior period or, where appropriate, have been restated; and**
2. **the accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.**

If the auditor becomes aware, during the current period, of a possible material misstatement in the comparative information, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient and appropriate audit evidence as to whether a material misstatement exists.

3.2.13 Special Considerations – Audits of financial statements prepared in accordance with Special-Purpose Frameworks

The auditor is required to determine the acceptability of the financial reporting framework that was applied when preparing the financial statements. In an audit of special-purpose financial statements, the auditor shall obtain an understanding of:

1. **the purpose for which the financial statements are prepared;**
2. **the intended users; and**
3. **the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.**

In planning and performing an audit of special-purpose financial statements, the auditor shall determine whether the circumstances of the engagement require special consideration to be given to application of these standards. When forming an opinion and reporting on special-purpose financial statements, the auditor shall comply with the same requirements as for general-purpose financial statements. The auditor's report on special-purpose financial statements shall:

1. describe the purpose for which the financial statements have been prepared; and
2. make reference to the management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances where the management has a choice of frameworks to use in preparing the financial statements.

The auditor shall include an Emphasis of Matter paragraph alerting users to the fact that the financial statements have been prepared in accordance with a special-purpose framework and that, as a result, they may not be suitable for another purpose.

3.2.14 Special Considerations – Audits of single financial statements and specific elements, accounts or items of a financial statement

In the case of an audit of a single financial statement, or of a specific element of a financial statement, the auditor shall first determine whether the audit is practicable. These standards also apply to audits of a single financial statement, or of a specific element of a financial statement, irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements.

The auditor shall consider whether the expected form of opinion is appropriate in the circumstances of the engagement, and shall adapt the reporting requirements as necessary. If the auditor is engaged to report on a single financial statement, or on a specific element of a financial statement, in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

If the opinion in the auditor's report on an entity's complete financial statements is modified, or the report includes an Emphasis of Matter paragraph or Other Matter paragraph, the auditor shall determine the effect this may have on the auditor's report on a single financial statement or a specific element of a financial statement. Where appropriate, the auditor shall modify the auditor's report on the single financial statement or specific element of a financial statement.

3.2.15 Considerations relevant to audits of Consolidated Financial Statements (including Whole of Public Sector Financial Statements)

While auditing the group financial statements, auditors shall obtain sufficient and appropriate audit evidence regarding the financial information of all components and the consolidation process to express an opinion as to whether the Consolidated Financial Statements (including whole-of-public sector financial statements) are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In situations where the audit is of consolidated financial statements, such as whole-of-public sector accounts, specific requirements and considerations may apply. The auditor carrying out an audit of consolidated financial statements is referred to as the principal auditor. The principal auditor shall establish a consolidated audit strategy and develop a consolidated audit plan. The principles for understanding the entity shall include an understanding of the group, its components and their environments, including group-wide controls, as well as the consolidation process. The understanding thus obtained shall be sufficient to confirm or revise the initial identification of components that are likely to be significant for the consolidated financial statements, and to assess the risks of material misstatement, whether due to fraud or error, of the consolidated financial statements.