Financial Audit and Performance Audit

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Certification Audit

- Audit of Financial statements prepared by the management
  - Profit and loss account
  - Balance sheet
- In audit, the auditor certifies whether the financial statements present true and fair view
- How the auditor does this?

Financial Reporting Framework

- All the financial statements are prepared by following the financial reporting framework applicable to the entity
- Financial reporting framework consists of all the standards, rules, regulations, guidelines etc. applicable to the entity
  - e.g. Accounting standards, accounting conventions and principles, formats of accounts, provisions of Companies Act, 1956, guidance notes issued by ICAI

Performance Audit

- Audit of the important activities of an organization or a scheme to examine them with respect to
  - Economy
  - Efficiency
  - Effectiveness
- Among these, Effectiveness is more important as this aspect is examined only in Performance Audit
- In Performance Audit, achievement of objectives is more important than the expenditure incurred

Relation between PA and FA

- How both kinds of audit are related?
- Financial statements are expression of the working of the entity as to how they are trying to achieve the objectives
    - For a profit making organization, profitability of the organisation shows how far objective is being achieved
    - For non-profit organisation, one can know whether the organisation is spending on the areas of objective or other areas
    - In case of government, it shows the priority areas of spending which can be compared with the objectives of government

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- Performance audit measures more about how well the expenditure is being done
- Audit of financial statements tells whether the expenditure has been incurred on the areas as claimed by the management
- Performance audit tells whether the expenditure incurred has actually translated into achievement of objectives

Similarities between FA and PA

- Both the audits aims to help the management ensure that the systems of organisation are so managed as to ensure achievement of objectives
- Both has to follow basic aspects of auditing:
  - Audit planning before execution
  - Establishment of audit objectives
  - Existence of criteria
  - Collection of sufficient and appropriate evidence
  - Opportunity to management to reply

Difference between PA and FA

Expertise required from Auditor

- While an accounting background helps an auditor conducting PA, it's absolutely necessary for an auditor conducting FA.
- An effective performance audit requires a professional with understanding of the technical aspects of the industry and the ability to understand business processes.
- Performance auditor should be able to see the bigger picture or the organization and should be able to go behind the activities being done

Audit Planning

- Audit Planning requires significant time in PA as it has to understand the entire gamut of activities of the entity in detail
- Auditor has to map various processes of the organisation
  - In FA, the auditor needs to understand activities of the entity in broad manner

Audit Objectives

- Audit objectives differ from one PA to another and generally include assessment of economy, efficiency and effectiveness of programme or organisation
- Generally, there are 3-5 objectives in each PA
- There are sub-objectives also in PA
  - In FA, the audit objective is mainly to examine whether the accounts of the organization presents true and fair/correct view

Audit Criteria

- Both PA and FA need Audit criteria
- Criteria in all FAs are mainly the Accounting standards and policies of the organisation which are fairly fixed and known
- In PA, standards differ from one PA to another
- The auditor has to make lots of efforts to identify the relevant standards for each audit
- A very important aspect of criteria in PA is that it should be acceptable to the management
- Credibility of the conclusions relies largely on the credibility of criteria
- Many a times in PA, the auditor may use Best practices of another organization as criteria
    - Even general principles of financial prudence can be criteria in PA

Coverage of Audit

- PA can cover entire organisation or only an aspect or a scheme of an organisation
  - FA normally covers entire organisation’s operations
- In PA, auditor examines all kinds of records related to execution of work
  - FA is restricted to examination of financial and other directly linked records
- An important aspect of PA to cover even those works which have not been executed by the management
  - This is absent in FA
- Examination of Internal Control system of the entity is an important aspect of any PA
- FA mainly covers one financial year only whereas PA covers 3 to 5 or sometimes 10 years

Collection of Evidence

- Though the basic methods of evidence gathering are same in PA and FA (Inquiry, examination of records, physical verification etc.), there are lots of difference in actual collection of evidences
- Multiplicity of evidences in respect of one aspect of PA
- Higher involvement of third parties in PA as compared to FA
- Higher complexity of evidence in PA with respect of sufficiency, relevance and reliability
- Easier use of Statistical sampling in FA

Audit Conclusion

- Conclusions in a PA are to be drawn carefully for each aspect of the objective
- This may lead to fixing of the responsibility in the organization for serious lapses
  - In FA, conclusion is to be mainly decided between a disclaimer, Adverse opinion, qualified opinion and unqualified opinion
  - In respect of observations of audit, mainly accounts department is responsible

Audit Recommendations

- For the management, recommendations of audit in PA are crucial outcome
- Audit should be very careful in suggesting recommendations as they should be practical and cost-effective
  - In FA, there are no recommendations.

Reporting

- Reporting is very significant aspect of PA.
- It is elaborate and should flow in logical manner keeping in mind the objectives of PA
- It should be in such a manner that a reasonably educated person can understand the report
- There are Reporting Standards which needs to be kept in mind while reporting a PA
  - In FA, reporting is fairly structured (standard formats) and runs into only few pages.

Impact of Audit

- PA reports can have significant impact on the management and the way organization is being run
- It can lead to changes in the policies of organisation/government
- It has potential to change the government sometimes
  - FA has limited impact in terms of changes in accounting policy and how the accounts wing functions

Follow-up of Audit

- PA reports are submitted to highest levels of management, mostly Legislature who takes keen interest in the recommendations given in PA
  - In FA, sometimes report is submitted to Legislature.
- Auditor keeps a watch on the remedial action taken based on the recommendations given in PA
  - The only remedial action can be revision of accounts
- Usually, a follow-up audit of the same issue/organisation is conducted after lapse of 5-7 years
  - No follow-up audit in FA.
  - FA report completes its lifecycle once the report is submitted to stakeholders

Using FA in PA

- Results of Financial Audit can be used while conducting Performance audit
  - FA is primary examination to ensure that management has maintained the basic required documents in respect of transactions
  - FS helps the PA auditor to identify the important areas of examination
  - It shows whether the areas of expenditure as shown in accounts are correctly depicted
  - Qualifications given by the FA auditor gives a lead to PA auditor on possible areas of problem

Using PA in FA

- Results of a Performance audit can be used in FA in following ways:
  - Most important benefit of PA report is that it gives the Financial auditor an idea about reliability of internal control system of the organisation
  - Detailed analysis of working of entity may give a lead to auditor to identify transactions not reported in the financial statements
  - PA report may reduce the work of Financial auditor in respect of physical verification of inventory and fixed assets

Thank You