Intermediate Course
Study Material
(Modules 1 to 2)

PAPER 6

AUDITING AND ASSURANCE

Module - 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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BEFORE WE BEGIN…

**Evolving role of a CA - Shift towards strategic decision making**

The traditional role of a chartered accountant restricted to accounting and auditing, has now changed substantially and there has been a marked shift towards strategic decision making and entrepreneurial roles that add value beyond traditional financial reporting. The primary factors responsible for the change are the increasing business complexities on account of plethora of laws, borderless economies consequent to giant leap in e-commerce, emergence of new financial instruments, emphasis on corporate social responsibility, significant developments in information technology, to name a few. These factors necessitate an increase in the competence of chartered accountants to take up the role of not merely an accountant or auditor, but a global solution provider. Towards this end, the scheme of education and training is being continuously reviewed so that it is in sync with the requisites of the dynamic global business environment; the competence requirements are being continuously reviewed to enable aspiring chartered accountants to acquire the requisite professional competence to take on new roles.

**Skill requirements at Intermediate Level**

Under the Revised Scheme of Education and Training, at the Intermediate Level, you are expected to not only acquire professional knowledge but also the ability to apply such knowledge in problem solving. The process of learning should also help you inculcate the requisite professional skills, i.e., the intellectual skills and communication skills, necessary for achieving the desired professional competence.

**Auditing – Core and Practical subject**

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide knowledge of generally accepted auditing procedures and techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoyable experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such learning would only help a student to become a better professional.
Know your Syllabus

The study material deals with the conceptual theoretical framework in detail.

In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations, diagrams, tables, flowcharts, screenshots etc. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the MCQs, Correct/Incorrect and other question.

For understanding the coverage of the syllabus, it is important to read the study material along with the Study Guidelines.

The entire syllabus has been divided into thirteen chapters.

**Chapter-1** discusses the basics of audit such as nature, scope, objectives, advantages, limitations etc. of audit. Also, Audit Engagement; Auditor’s Independence; Role of International Auditing and Assurance Standards Board (IAASB) & Auditing and Assurance Standards Board (AASB) have been discussed.

**Chapter-2** is devoted to Audit Strategy; Audit planning and Audit programme;

**Chapter-3** focusses on Audit Documentation; Audit evidence; Related Party Transactions, Written Representations, External Confirmations, Subsequent Events, Going Concern.

**Chapter-4** is devoted to Audit Risk, Identifying and Assessing the Risk of Material Misstatement, Risk Assessment procedures; Understanding the entity and its environment; Internal Control.

**Chapter-5** discusses the Responsibility for the Prevention and Detection of Fraud; Fraud Risk Factors; Risks of Material Misstatement Due to Fraud; Communication of Fraud.

**Chapter-6** extensively deals with the Impact of IT related Risks, Impact on Controls, Internal Financial Controls, Audit approach, Understanding and documenting Automated environment, data analytics for audit.

**Chapter-7** discusses about Audit Sampling.

**Chapter-8** deals with analytical procedures.

**Chapter-9** is devoted to the Audit of Items of Financial Statements. **Chapter-10** discusses about the provisions of the Company Audit. **Chapter-11** discusses about various aspects of Auditor’s Report.
**Chapter-12** deals with the Audit of Banks.

**Chapter-13** extensively deals with the Appointment of Auditor, Audit Procedure and Audit Report in respect of different Category of Entities.

**Structure of the Study Material**
The content for each chapter/unit at the Intermediate level has been structured in the following manner –

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<td>2. Chapter Overview</td>
<td>As the name suggests, this chart/table would give a broad outline of the contents covered in the chapter.</td>
</tr>
<tr>
<td>3. Introduction</td>
<td>A brief introduction is given at the beginning of each chapter/unit which would help you get a feel of the topic.</td>
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<td>4. Content</td>
<td>The concepts and provisions of law/standard are explained in student-friendly manner with the aid of Examples/illustrations/diagrams/flow charts. These value additions would help you develop conceptual clarity and get a good grasp of the topic. Diagrams and Flow charts would help you understand the concept/provision in a better manner. Illustrations would help you understand the application of concepts/provisions.</td>
</tr>
<tr>
<td>5. Exercise Questions with Answers</td>
<td>The exercise questions and answers would help you to apply what you have learnt in problem solving. In effect, it would sharpen your application skills and test your understanding as well as your application of concepts/provisions.</td>
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<td>6. Let Us Recapitulate</td>
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We hope that these student-friendly features in the Study Material makes your learning process more enjoyable, enriches your knowledge and sharpens your application skills.

*Happy Reading and Best Wishes!*
Objective:
To develop an understanding of the concepts in auditing and of the generally accepted auditing procedures, techniques and skills and acquire the ability to apply the same in audit and attestation engagements.

1. Nature, Objective and Scope of Audit

   **Auditing Concepts**: Nature, objective and scope of Audit; Relationship of auditing with other disciplines;

   **Standard Setting Process**: Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board (IAASB) & Auditing and Assurance Standards Board (AASB); Standards on Auditing, Guidance Note(s) issued by the ICAI;

   **Engagement Standards**: Qualities of Auditor, Elements of System of Quality Control (SQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements); Ethical requirements relating to an audit of financial statements; Inherent Limitations of an audit (SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing); Preconditions for an audit; Audit Engagement; Agreement on Audit Engagement Terms; Terms of Engagement in Recurring Audits (SA 210 Agreeing the Terms of Audit Engagements); Leadership Responsibilities for Quality on Audits; Concept of Auditor’s Independence; Threats to Independence; Acceptance and Continuance of Client Relationships and Audit Engagements (SA 220 Quality Control for an Audit of Financial Statements).

2. Audit Strategy, Audit Planning and Audit Programme: Audit Strategy; Audit planning (SA 300 Planning an Audit of Financial statements); Audit programme; Development of Audit Plan and Programme, Control of quality of audit work - Delegation and supervision of audit work; Materiality and Audit Plan; Revision of Materiality; Documenting the Materiality; Performance Materiality (SA 320 Materiality in Planning and Performing an Audit).
3. **Audit Documentation and Audit Evidence:** Concept of Audit Documentation; Nature & Purpose of Audit Documentation; Form, Content & Extent of Audit Documentation; Completion Memorandum; Ownership and custody of Audit Documentation (SA 230 Audit Documentation); Audit procedures for obtaining audit evidence; Sources of evidence; Relevance and Reliability of audit evidence; Sufficient appropriate audit evidence, Evaluation of Audit Evidence (SA 500 Audit Evidence); Written Representations as Audit Evidence; Objective of Auditor regarding Written Representation; Management from whom Written Representations may be requested; Written Representations about Management’s Responsibilities (SA 580 Written Representations); Obtaining evidence of existence of inventory; Audit procedure to identify litigation & claims (SA 501 Audit Evidence - Specific Considerations for Selected Items); External confirmation procedures; Management’s refusal to allow the auditor to send a confirmation request; Negative Confirmations (SA 505 External Confirmations); Audit evidence about opening balances; Accounting policies relating to opening balances; Reporting with regard to opening balances (SA 510 Initial Audit Engagements-Opening Balances); Meaning of Related Party; Nature of Related Party Relationships & Transactions; Understanding the Entity’s Related Party Relationships & Transactions (SA 550 Related Parties); Meaning of Subsequent Events; Auditor’s obligations in different situations of subsequent events (SA 560 Subsequent Events); Responsibilities of the Auditor with regard to Going Concern Assumption; Objectives of the Auditor regarding Going Concern; Events or Conditions that may cast doubt about Going Concern Assumption; Audit Procedures when events or conditions are identified (SA 570 Going Concern).

4. **Risk Assessment and Internal Control:** Audit Risk, Identifying and Assessing the Risk of Material Misstatement, Risk Assessment procedures; Understanding the entity and its environment; Internal control, Documenting the Risks; Evaluation of internal control system; Testing of Internal control; Internal Control and IT Environment (SA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment); Materiality and audit risk (SA 320 Materiality in Planning and Performing an Audit); Internal audit, Basics of Standards on Internal Audit (SIAs) issued by the ICAI; Basics of Internal Financial Control and reporting requirements; Distinction between Internal Financial Control and Internal Control over Financial Reporting.

5. **Fraud and Responsibilities of the Auditor in this Regard:** Responsibility for the Prevention and Detection of Fraud; Fraud Risk Factors; Risks of Material Misstatement Due to Fraud; Communication of Fraud (SA 240 The
Auditor’s responsibilities Relating to Fraud in an Audit of Financial Statements); Provisions of the Companies Act 2013 relating to fraud and rules thereunder including reporting requirements under CARO.

6. **Audit in an Automated Environment:** Key features, Impact of IT related Risks, Impact on Controls, Internal Financial Controls as per Regulatory requirements, Types of Controls, Audit approach, Understanding and documenting Automated environment, Testing methods, data analytics for audit, assessing and reporting audit findings.

7. **Audit Sampling:** Meaning of Audit Sampling; Designing an audit sample; Types of sampling; Sample Size and selection of items for testing; Sample selection method (SA 530 Audit Sampling).

8. **Analytical Procedures:** Meaning, nature, purpose and timing of analytical procedures; Substantive analytical procedures, Designing and performing analytical procedures prior to Audit; investigating the results of analytical procedures (SA 520 Analytical Procedures).

9. **Audit of Items of Financial Statements:** Audit of sale of Products and Services; Audit of Interest Income, Rental Income, Dividend Income, Net gain/loss on sale of Investments etc.

Audit of Purchases, Employee benefits expenses, Depreciation, Interest expense, Expenditure on Power & Fuel, Rent, Repair to building, Repair to Machinery, Insurance, Taxes, Travelling Expenses, Miscellaneous Expenses etc.


Audit of Land, Buildings, Plant & Equipment, Furniture & Fixtures, Vehicles, Office Equipments, Goodwill, Brand/Trademarks, Computer Software etc.

Audit of Loan & Advances, Trade Receivable, Inventories, Cash & Cash Equivalent, Other Current Assets. Audit of Contingent Liabilities.

(The list of items is illustrative only)

10. **The Company Audit:** Eligibility, Qualifications and Disqualifications of Auditors; Appointment of auditors; Removal of auditors; Remuneration of Auditors; Powers and duties of auditors; Branch audit; Joint audit; Reporting requirements under the Companies Act, 2013 including CARO; Other Important Provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder.

11. **Audit Report:** Forming an opinion on the Financial Statements; Auditor’s Report- basic elements (SA 700 Forming an Opinion and Reporting on Financial Statements); Types of Modified Opinion; Circumstances When a
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12. **Audit of Banks:** Understanding of accounting system in Banks, Audit Approach, Audit of Revenue items, Special Consideration in Bank Audit with emphasis on Advances and NPAs.

13. **Audit of Different Types of Entities:** Appointment of Auditor, Audit Procedure and Audit Report in respect of different Category of Entities: Government; Local bodies and Not-for-profit organizations; Partnership Firms, Audit of different type of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals Basics of Limited Liability Partnerships (LLPs) audit and Co-operative Societies Audit.

**Note:**
(i) The specific inclusions/exclusions, in any topic covered in the syllabus, will be effected every year by way of Study Guidelines.

(ii) The provisions of the Companies Act, 1956 which are still in force would form part of the syllabus till the time their corresponding or new provisions of the Companies Act, 2013 are enforced.

(iii) If new legislations/ Standards on Auditing/Guidance Notes/Statements are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute. The changes in this regard would also form part of Study Guidelines.
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After studying this chapter, you will be able to:

- Understand the functional classification and qualities of an auditor.
- Define audit and understand the objectives of audit, principles governing audit etc.
- Distinguish between auditing and investigation.
- Understand different types of audit and relationship of auditing with other disciplines.
1. MEANING AND DEFINITION OF AUDITING

“An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements. 

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

(i) the accounts have been drawn up with reference to entries in the books of account;
(ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
(iv) the information conveyed by the statements is clear and unambiguous;
(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

2. OBJECTIVES OF AUDIT

As per SA-200 “Overall Objectives of the Independent Auditor”, in conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and
(b) To report on the financial statements, and communicate as required by the SAAs, in accordance with the auditor’s findings.
3. **SCOPE OF AUDIT**

The following points merit consideration in regard to scope of audit:

1. The audit should **be organized to cover adequately all aspects of the enterprise** relevant to the financial statements being audited.

2. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether **the information contained in the underlying accounting records and other source data is reliable** and sufficient as the basis for the preparation of the financial statements.

3. In forming his opinion, the auditor should also **decide whether the relevant information is properly disclosed in the financial statements** subject to statutory requirements, where applicable.

4. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:
   
   (a) making a study and evaluation of accounting systems and internal controls and
   
   (b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

5. **The auditor determines whether the relevant information is properly disclosed in the financial statements by:**

   (a) **comparing the financial statements with the underlying accounting records and other source data** to see whether they properly summarize the transactions and events recorded therein; and
1.4 AUDITING AND ASSURANCE

(b) considering the judgments that management has made in preparing the financial statements accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

6. The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

7. Constraints on the scope of the audit of financial statements that impair the auditor’s ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

3.1 Aspects to be covered in Audit

The principal aspects to be covered in an audit concerning final statements of account are the following:

(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

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(ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.

(iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.

(vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.
Assertions about account balances at the period end:

(a) **Existence**—assets, liabilities, and equity interests exist.

(b) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(c) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.

(d) **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(viii) **Verification of the liabilities stated** in the balance sheet.

(ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.

(x) **Where audit is of a corporate body, confirming that the statutory requirements** have been complied with.

(xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

**Definition of Assertions:** It refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

(Note: For detailed discussion on assertions, students may refer Chapter 3- Audit Documentation and Audit Evidence)

### 4. TYPES OF AUDIT

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

(i) **Audit required under law**: The organisations which require audit under law are the following: e.g companies governed by the Companies Act; banking companies; other statutory bodies required by their regulators or by specific Act.

(ii) **In the voluntary category** are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required
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to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special features which will be seen later.

As already stated, the auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. Also it is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made. Furthermore, to ensure that the report will be brought to the notice of all concerned, the accounts should bear reference to the report.

A special reference is necessary for non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income. What makes them distinct, is the absence of the question of division of profit: any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts are of the supreme importance are often widows and minors, who cannot criticize the accounts in any effective manner. Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contain a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.
5. ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

(a) **It safeguards the financial interest of persons who are not associated** with the management of the entity, whether they are partners or shareholders, bankers, FI’s, public at large etc.

(b) **It acts as a moral check on the employees** from committing defalcations or embezzlement.

(c) Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.

(d) These are **also useful for settling trade disputes** for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur...
due to the absence or inadequacy of internal checks or internal control measures.

(f) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(g) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(i) Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

6. INHERENT LIMITATIONS OF AUDIT

As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”,

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

(i) The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

(ii) The Nature of Audit Procedures: There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(iii) Timeliness of Financial Reporting and the Balance between Benefit and Cost: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

(iv) Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor’s ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

ILLUSTRATION

MNO Ltd requested the auditor CA P to provide for absolute assurance in respect of its ten branches scattered in Delhi and confirm that the financial statements are free from material misstatement due to fraud or error. Advise.

SOLUTION

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from
material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive.

In view of the above, CA P cannot provide audit absolute assurance to MNO Ltd in respect of its branches.

| Inherent Limitations of Audit (SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”): The auditor is not expected to, and cannot, reduce audit risk to zero because there are inherent limitations of an audit. The inherent limitations of an audit arise from: |
|---|---|---|
| The Nature of Financial Reporting: The preparation of financial statements involves judgment by management. |
| The Nature of Audit Procedures: There are practical and legal limitations on the auditor’s ability to obtain audit evidence such as: |
| Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS. | Fraud may involve sophisticated and carefully organised schemes. | An audit is not an official investigation into alleged wrongdoing. |

| Timeliness of Financial Reporting and the Balance between Benefit and Cost: Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. |
|---|---|
| Other Matters that Affect the Limitations of an Audit: Certain assertions or subject matters are particularly significant, such assertions or subject matters include: |
| • Fraud, particularly involving senior management or collusion. | • The occurrence of non-compliance with laws and regulations. |
| • The existence and completeness of related party relationships and transactions. | • Future events or conditions that may cause an entity to cease to continue as a going concern. |
ILLUSTRATION

DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2015-2016. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor. Comment.

SOLUTION

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor’s report based on an evaluation of that evidence in light of the overall objectives of the auditor.

7. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

The field of auditing as a discipline in simple words involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.
Auditing and Accounting: Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

Auditing and Law: An auditor should have a good knowledge of business laws affecting the entity.

Auditing and Economics: Auditor is expected to be familiar with the overall economic environment of the client.

Auditing and Behavioural Science: Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.

Auditing and Statistics & Mathematics: Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.

Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.

Auditing and Financial Management: The auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.

Auditing and Production: Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

7.1 Auditing and Accounting

It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.
7.2 Auditing and Law

The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

7.3 Auditing and Economics

As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

7.4 Auditing and Behavioural Science

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the
organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

7.5 Auditing and Statistics & Mathematics

With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories. The use of data analytics is advancing rapidly in auditing where many organizations are using continuous auditing and continuous monitoring of data to identify risks as part of their system of internal control.

7.6 Auditing and Data Processing

Today, organisations are witnessing revolution in the field of data processing of accounts. Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, Computerised Information System auditing in itself is developing as a discipline in itself.

7.7 Auditing and Financial Management

Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.
7.8 Auditing and Production

Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.

8. STANDARD SETTING PROCESS

8.1 Role of International Auditing and Assurance Standards Board

In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
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- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

**International Auditing and Assurance Standards Board (IAASB):** The IFAC Board has established the IAASB to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IAASB functions as an independent standard-setting body under the auspices of IFAC.

**Auditing and Assurance Standards Board:** ICAI is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. ICAI constituted the AASB (erstwhile Auditing Practices Committee) to review the existing auditing practices in India and to develop Engagement and Quality Control Standards (erstwhile Statements on Standard Auditing Practices) so that these may be issued by the Council of the Institute.

8.2 Role of Auditing and Assurance Standards Board

The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the applicable laws, customs, usages and business environment in India. In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of
SAPs had also been changed to Auditing and Assurance Standards (AASs).

A major development in the field of auditing has been the issuance of revised and/or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards: In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

- **SAs**: apply in the audit of historical financial information.
- **SREs**: apply in the review of historical financial information.
- **SAEs**: apply in assurance engagements, dealing with subject matters other than historical financial information.
- **SRSs**: apply to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.
These Standards will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

While discharging their attest function, it will be the duty of members of the Institute to ensure that the Standards are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the Standards, his report should draw attention to the material departures therefrom, auditors will be expected to follow Standards in the audits commencing on or after the date specified in the statement. Remember all Standards.
are mandatory from the date mentioned herein and it is obligatory upon members of Institute to adhere to these whenever an audit is carried out.

All relevant Standards which are important from students' viewpoint have been covered as an integral part of the text.

**Compliance with Documents Issued by the Institute:** The Institute has, from time to time, issued ‘Guidance Notes’ and ‘Statements’ on a number of matters. The ‘Statements’ have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. ‘Statements’ therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

(a) to examine whether ‘Statements’ relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the ‘Statements’, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and

(b) to ensure that the ‘Statements’ relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such ‘Statements’, his report should draw attention to the material departures, therefrom.

‘Guidance Notes’: are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are however a few guidance notes in case of which the Council has specifically stated (discussed in Announcements part reproduced in Handbook on Auditing Pronouncements) that they should be considered as mandatory on members while discharging their attest function.
9. QUALITIES OF AN AUDITOR

It is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be.
as regards the personal qualities. He said, “an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true”.

10. ELEMENTS OF A SYSTEM OF QUALITY CONTROL

The firm’s system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm.
(b) Ethical requirements.
(c) Acceptance and continuance of client relationships and specific engagements.
(d) Human resources.
(e) Engagement performance.
(f) Monitoring.

10.1 Leadership Responsibilities for Quality on Audits

As per SA 220 “Quality Control for an Audit of Financial Statements”, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

   (i) Performing work that complies with professional standards and regulatory and legal requirements;
   
   (ii) Complying with the firm’s quality control policies and procedures as applicable;
   
   (iii) Issuing auditor’s reports that are appropriate in the circumstances; and
   
   (iv) The engagement team’s ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.
Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor’s report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

10.2. Ethical Requirements Relating to an Audit of Financial Statements

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior.

The auditor should be independent of the entity subject to the audit. The Code describes independence as comprising both-

Independence of Mind and Independence in Appearance.

The auditor’s independence safeguards the auditor’s ability to form an audit opinion without being affected by any influences. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Standard on Quality Control (SQC) 1 sets out the responsibilities of the firm for establishing policies and procedures regarding compliance with relevant ethical requirements.

SA 220 sets out the engagement partner’s responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements. SA 220
recognises that the engagement team is entitled to rely on a firm’s systems in meeting its responsibilities with respect to quality control procedures.

10.2.1 Independence of Auditors

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

It is not possible to define “independence” precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term ‘Independence’ as follows:

“Independence is: (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor’s integrity, objectivity or professional skepticism had been compromised.”

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. The auditor’s opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user should not assume that the auditor’s opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

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 as being incompatible with
integrity and objectivity.

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

10.2.2 Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client’s fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.

2. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

3. **Advocacy threats**, which occur when the auditor promotes, or is perceived to promote, a client’s opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client’s advocate in litigation and third party disputes.

4. **Familiarity threats** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client’s interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of
the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

5. **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

**10.2.3 Safeguards to Independence**

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.

5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

**10.2.4 Professional Skepticism**

**Professional skepticism** refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.
Professional skepticism includes being alert to, for example:

♦ Audit evidence that contradicts other audit evidence obtained.
♦ Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
♦ Conditions that may indicate possible fraud.
♦ Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
♦ Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
♦ Overlooking unusual circumstances.
♦ Over generalising when drawing conclusions from audit observations.
♦ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

10.3. Acceptance and Continuance of Client Relationships and Audit Engagements

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed:
SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:

♦ The integrity of the principal owners, key management and those charged with governance of the entity;
♦ Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
♦ Whether the firm and the engagement team can comply with relevant ethical requirements; and
♦ Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

### 10.4 Human Resources

The firm should establish **policies and procedures** designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

**Such policies and procedures address the following personnel issues:**

(a) Recruitment;
(b) Performance evaluation;
(c) Capabilities;
(d) Competence;
(e) Career development;
(f) Promotion;
(g) Compensation; and
(h) Estimation of personnel needs.
Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm’s engagements. The firm’s recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm’s work.

**10.5 Engagement Performance**

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

**10.6 Monitoring**

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) Adherence to professional standards and regulatory and legal requirements;
(b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm’s quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

11. PRECONDITIONS FOR AN AUDIT

As per SA 210 “Agreeing the Terms of Audit Engagements”, preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

   (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

   (ii) For the internal control as management considers necessary; and

   (iii) To provide the auditor with:

       ➢ Access to all information such as records, documentation and other matters;

       ➢ Additional information that the auditor may request from management for the purpose of the audit; and
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Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

12. AGREEMENT ON AUDIT ENGAGEMENT TERMS

Legal requirement to get the accounts audited so far extends only to companies, registered societies etc. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. It is, therefore important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work. The audit engagement letter is sent by the auditor to his client. The ICAI has issued SA 210 “Agreeing the Terms of Audit Engagements” on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed. The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid.

According to SA 210 “Agreeing the Terms of Audit Engagements”, the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(a) The objective and scope of the audit of the financial statements;
(b) The responsibilities of the auditor;
(c) The responsibilities of management;
(d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

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If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

13. RECURRING AUDITS

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity’s business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

ILLUSTRATION

R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients for last 5 years despite changes in business and professional environment.

Required

Elucidate the circumstances that may warrant the revision in terms of engagement.

SOLUTION

As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the factors that may make it appropriate to revise the terms of
the audit engagement or to remind the entity of existing terms are discussed in para 14 above.

14. LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Analysis

— If management or TCWG
— impose limitation on the scope
— such that auditor believes
— limitation would result in
— auditor disclaiming an opinion
— the auditor shall not accept such a limited engagement

15. ACCEPTANCE OF A CHANGE IN ENGAGEMENT

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from-

1. a change in circumstances affecting the need for the service,
2. a misunderstanding as to the nature of an audit or related service originally requested.
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.
The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SASs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

(a) the original engagement; or

(b) any procedures that may have been performed in the original engagement.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation; and
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(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

ILLUSTRATION

M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh.

Required

State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

SOLUTION

Relying on Work Performed by Another Auditor: As per SA 220 “Quality Control for an Audit of Financial Statements”, an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor’s report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor’s professional responsibilities and which should be complied with wherever an audit is carried, is that 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. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other
In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

**CASE STUDY**

Mr. Veeru of Delhi has started a new business of selling of Handloom items. He purchases these items from a factory situated in Ludhiana and sells to local customers at a price which gives him reasonable amount of profit. All gets well in the first year and he earns some income from the business.

However, he feels that he could expand this business if he was able to bring more items to the place where he sells them and also he is aware of the fact that there are several other locations as well where he could sell these items. He could achieve this by buying a van and by employing other people who will assist him in his business on the other locations.

He needs more money to achieve this expansion of his business. He decides to ask his friend Raju to invest in the business.

Having seen the potential of Veeru’s business, Raju wants to invest, but neither he wants to manage nor wants to have ultimate liability for the debts of the business in case business fails. He therefore suggested that they should set up a proprietary firm. He will be the owner of the firm and will be entitled to profits. On the other hand, Veeru would be the Manager and be paid a salary.

At the end of the first year of trading when Raju receives copy of the financial statements, he finds that Profits are much lower than what was expected. Raju knows that Veeru is paid salary so he may not care for low profits. Raju is concerned by the level of profits and feels that he wants further assurance on the accounts. He does not know whether the accounts give a true and fair view of the last year’s trading because the profits do not seem as high as those Veeru had predicted when he agreed to invest.

Raju seeks solution for his problem.

The solution is that the assurance Raju is seeking may be given by an Independent Audit of accounts.
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SUMMARY

An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. The person conducting this task should take care to ensure that financial statements would not mislead anybody. As per SA-200 “Overall Objectives of the Independent Auditor”, in conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and to report on the financial statements. The auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics.

The auditor shall comply with relevant ethical requirements including those pertaining to independence. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. The Code establishes the five fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. (a) Integrity; (b) Objectivity; (c)Professional competence and due care; (d) Confidentiality; and (e) Professional behavior.
TEST YOUR KNOWLEDGE

MCQs

1. __________ along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession.
   (a) Auditing
   (b) Taxation
   (c) Finance
   (d) Taxation and Finance both

2. No business or institution can effectively carry on its activities without the help of proper __________:
   (a) Audit
   (b) Record and accounts
   (c) neither (a) nor (b)
   (d) both (a) and (b)

3. As per SA-200 “Overall Objectives of the Independent Auditor”, in conducting an audit of financial statements, the overall objectives of the auditor are:
   (a) To obtain reasonable assurance
   (b) To report on the financial statements
   (c) Both (a) and (b) above
   (d) None of the above

4. (IESBA Code) related to an audit of financial statements establishes which of the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:
   (a) Integrity;
   (b) Objectivity;
   (c) Professional competence and due care;
   (d) All of the above

5. The auditor’s ________ safeguards the auditor’s ability to form an audit opinion without being affected by any influences.
(a) Objectivity
(b) independence
(c) Confidentiality
(d) Integrity

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

(i) The basic objective of audit does not change with reference to nature, size or form of an entity
(ii) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements
(iii) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.
(iv) The audit engagement letter is sent by the client to auditor.
(v) Specific disclosure is required of the fundamental accounting assumptions followed in the financial statements.

Theoretical Questions

1. Explain clearly meaning of Auditing. How would you as an auditor perform the audit.
2. “The independent audit of an entity’s financial statements is a vital service to investors, trade payables, and other participants in economic exchange”. Explain
3. State the objectives of Audit according to SA 200

ANSWERS/SOLUTIONS

Answers to MCQs

1. (a) 2. (b) 3. (c) 4. (d) 5. (b)
Answers to Correct/Incorrect

(i)  Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

(ii) Correct: As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(iii) Correct: As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive.

(iv) Incorrect: As per SA 210 “Agre eing the Terms of Audit Engagements”, the Audit engagement letter is sent by the auditor to his client.

(v) Incorrect, as per AS 1, “Disclosure of Accounting Policies”, specific disclosure of the fundamental accounting assumption is required if they are not followed in the financial statements.

Answers to Theoretical Questions

1. Refer 1: Meaning and Definition of Auditing.

2. Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different of time with numerous persons and entities. The effect of all transactions has to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to
measure the success of whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organization or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic. In today’s economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity’s financial statements is a vital service to investors, trade payable, and other participants in economic exchange.

3. Refer para 2: Overall Objectives of Audit.

4. Refer para 11.2.2: Threats to Independence.
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the Audit Planning and Overall Audit Strategy for an audit.
- Draft audit programme.
- Understand Audit Planning and Materiality.
- Learn to develop the Audit Plan and Program.
- Gain the knowledge of control of quality of audit work w.r.t delegation and supervision of audit work.
1. AUDIT PLANNING

1.1 Audit Plan to Conduct an Effective Audit

“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business”.

**Plans should be made to cover, among other things:**

(a) acquiring knowledge of the client’s accounting systems, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

**Plans should be further developed and revised** as necessary during the course of the audit.

SA-300, “Planning an Audit of Financial Statements” further expounds this principle. According to it, **planning is not a discrete phase of an audit, but rather a continual and iterative process** that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

1.2 Benefits of Planning in the Audit of Financial Statements

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

(a) Helping the auditor to devote appropriate attention to important areas of the audit.

(b) Helping the auditor identify and resolve potential problems on a timely basis.

(c) Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
(d) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

(e) Facilitating the direction and supervision of engagement team members and the review of their work.

(f) Assisting, where applicable, in coordination of work done by auditors of components and experts.

2. AUDIT STRATEGY

2.1 Overall Audit Strategy – Assistance to auditor

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor’s risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;

2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material

* [www.Audit-is-cool.blogspot.com](http://www.Audit-is-cool.blogspot.com)

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locations, the extent of review of other auditors’ work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and

4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

ILLUSTRATION

The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit.

Required

How the audit strategy would be helpful to the auditor?

SOLUTION

Refer Para 1.2 for solution

2.2 Establishment of Overall Audit Strategy

In establishing the overall audit strategy, the auditor shall

(a) Identify the characteristics of the engagement that define its scope;

Example

♦ The expected audit coverage, including the number and locations of components to be included.

♦ The nature of the business segments to be audited, including the need for specialized knowledge.

♦ The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

Example

♦ The entity’s timetable for reporting, such as at interim and final stages.
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♦ The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.

♦ The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor’s report, management letters and communications to those charged with governance.

♦ The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

(c) Consider the factors that, in the auditor’s professional judgment, are significant in directing the engagement team’s efforts;

(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

3. RELATIONSHIP BETWEEN OVERALL AUDIT STRATEGY AND AUDIT PLAN

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor’s resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.

4. DEVELOPMENT OF AUDIT PLAN

4.1 Description of Audit Plan

The auditor shall develop an audit plan that shall include a description of

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.

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(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 “The Auditor’s Responses to Assessed Risks”.

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

**Example**

Planning of the auditor’s risk assessment procedures occurs early in the audit process.

However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

### 4.2 Knowledge of the Client’s Business

It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client’s business, a proper audit is not possible. As per SA-315, “Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment”, the auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.

**Example**

- The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
- Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- Technological developments, such as those related to the entity’s products, energy supply and cost.
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♦ The effect of regulation on entity operations.

(b) The nature of the entity, including:
   (i) its operations;
   (ii) its ownership and governance structures;
   (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   (iv) the way that the entity is structured and how it is financed;


to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

Example

♦ Understanding the sources of an entity’s earnings can help us identify risks of material misstatement related to valuation of certain products or lines of businesses or areas that may be more susceptible to management fraud.

♦ Understanding key supplier and customer relationships can help us identify potential related parties or risks related to revenue recognition.

♦ An entity with components in multiple tax jurisdictions, resulting in additional risk of misstatement in the tax accounts.

♦ An acquisition may result in a complex structure of holding companies to achieve benefits to the shareholders giving rise to significant intercompany transactions which may give rise to material misstatements due to fraud or error.

♦ Transactions outside the entity’s normal course of business may include: complex equity transactions, transactions regarding the leasing of premises, or the rendering of management services by the entity to another party, when no consideration is exchanged, transactions under contracts with terms that change before expiration should be studied in depth.

(c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
Example

1. We use our understanding of the entity’s accounting principles, financial reporting policies or disclosures to help us determine:
   - The need to involve a specialist to help perform audit procedures related to particular disclosures, such as pension disclosures.
   - The effect on our audit of significant new or revised disclosures that may be required as a result of changes in the entity’s environment, financial condition or activities, such as a change in the segments for the reporting of segment information arising from a significant business combination.

2. Management determines that most of the entity’s competitors have adopted an accounting policy that is different from that adopted by the entity. After evaluation, management determines that the alternative accounting policy is generally accepted and further determines that the alternative accounting policy preferable as it will result in greater comparability and result in reliable and more relevant information. Management therefore decides to change the entity’s accounting policy.

(d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement.

Example

1. If one of management’s objectives is to grow the business, management may develop a strategy of steady but regular growth through specific marketing campaigns and development of new markets. Alternatively, management may develop a more aggressive, complex strategy of acquiring competitors. Each of these strategies gives rise to differing business risks and potentially differing risks of material misstatement.

2. Examples of potential business risks include:
   - Failure to keep up to date with new products, technologies or services.
   - Excessive reliance on a key supplier, product or individual, such as the owner.
   - Lack of personnel with expertise to react to changes in the industry.
   - Insufficient or excessive production capacity caused by inaccurate estimation of demand.
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- Loss of financing due to the entity’s inability to meet financial covenants.

(e) The measurement and review of the entity’s financial performance.

Example

External information such as analysts’ reports and credit rating agency reports may be useful information for us to obtain an understanding of an entity’s performance measures. Such reports can often be obtained from the entity.

In addition to the importance of knowledge of the client’s business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations and to make judgements regarding the appropriateness of accounting policies and disclosures.

5. AUDIT PLANNING – A CONTINUOUS PROCESS

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor’s identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

6. OVERALL AUDIT STRATEGY AND THE AUDIT PLAN – THE AUDITOR’S RESPONSIBILITY

The auditor may decide to discuss elements of planning with the entity’s management to facilitate the conduct and management of the audit engagement.
Example

To coordinate some of the planned audit procedures with the work of the entity’s personnel.

Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor’s responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

Example

Discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

ILLUSTRATION

W, the auditor of SKM Ltd asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insist him to draw detailed audit procedures also. On the request of auditor W, complete audit strategy as well as audit procedures are prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

SOLUTION

Refer paragraph 5, Keeping in view the content given in paragraph 5, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures

7. CHANGES TO PLANNING DECISIONS DURING THE COURSE OF THE AUDIT

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the
case when information comes to the auditor’s attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

8. DIRECTION, SUPERVISION AND REVIEW

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement

**Example**

An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.

4. The capabilities and competence of the individual team members performing the audit work.

**Example**

We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity’s process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior’s involvement requires judgment, taking into consideration the complexity of the area and the experience of the team.
9. DOCUMENTATION OF AUDIT PLAN

The auditor shall document:

(a) the overall audit strategy;
(b) the audit plan; and
(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Example

The auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Example

The following things should form part of auditor’s documentation:

- A summary of discussions with the entity’s key decision makers.
- Documentation of audit committee pre-approval of services, where required.
- Audit documentation access letters.
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
10. AUDIT PROGRAMME

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Definition: An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

10.1 Evolving One Audit Programme – Not Practicable For All Businesses

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

10.2 The Assistant Engaged - Be Encouraged To Keep An Open Mind

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of

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situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

**10.3 Periodic Review of The Audit Programme**

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

*Example*

If the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [Pacific Acceptance Corporation Ltd. v. Forsyth and Others.]

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client’s operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

**10.4 Constructing an Audit Programme**

For the purpose of programme construction, the following points should be
kept in mind:

(1) Stay within the scope and limitation of the assignment.
(2) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
(3) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
(4) Consider all possibilities of error.
(5) Co-ordinate the procedures to be applied to related items.

10.5 Audit Programme - Designed to provide Audit Evidence

Audit Evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

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Example

Sales are evidenced by:

(i) invoices raised by the client;
(ii) price list;
(iii) forwarding notes to client;
(iv) inventory-issue records;
(v) sales managers’ advice to the inventory section;
(vi) acknowledgements of the receipt of goods by the customers; and
(vii) collection of money against sales by the client.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

(a) Documentary examination,
(b) Physical examination,
(c) Statements and explanation of management, officials and employees,
(d) Statements and explanations of third parties,
(e) Arithmetical calculations by the auditor,
(f) State of internal controls and internal checks,
(g) Inter-relationship of the various accounting data,
(h) Subsidiary and memorandum records,
(i) Minutes,
(j) Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is ‘count’
2. For investment pledged with a bank, the banker’s certificate.
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3. For verifying assertions about book debts, the client’s ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word “available” we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

10.6 Developing the Audit Programme

1. **Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

2. **Audit Objective and Instruction to Assistants:** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

3. **Reliance on Internal Controls:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

4. **Timings of Performance of Audit Procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
5. **Audit Planning:** The audit planning ideally commences at the conclusion of the previous year’s audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor’s review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

### 10.7 Advantages and Disadvantages of an Audit Programme

**The advantages of an audit programme are:**

(a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.

(b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.

(c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.

(d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some ‘mental’ plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.
(e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.

(f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.

(g) It serves as a guide for audits to be carried out in the succeeding year.

(h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

Some disadvantages are also there in the use of audit programmes but most of these can be removed by following some concrete steps.

**The disadvantages are:**

(a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(c) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.
11. QUALITY CONTROL FOR AUDIT WORK—DELEGATION AND SUPERVISION OF AUDIT WORK

An audit is a complex task involving number of people at different levels. As we observed in the preparation and development of audit programme, the auditor would naturally have to depend upon number of technical experts as well. During the course of his work, the auditor is also likely to use the work performed by other auditors also.

A lot of work is delegated by auditor to his assistants. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose. SA 220, “Quality Control for an Audit of Financial Statements” lays down standards on the quality control.

The objective of the auditor is to implement quality control procedures at the engagement level that provides the auditor with reasonable assurance that:

(a) The audit complies with professional standards and regulatory and legal requirements; and

(b) The auditor’s report issued is appropriate in the circumstances.

12. AUDIT PLANNING AND MATERIALITY

Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on “Materiality in Planning and Performing an Audit” requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor’s preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. It may be noted that the auditor’s assessment of materiality and audit risk may be different at the time of initially planning of the audit as
against at the time of evaluating the results of audit procedures.

**12.1 Determining Materiality and Performance Materiality when Planning the Audit**

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

**Performance Materiality defined**: Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

**12.1.1 Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole**

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements

**Example**

Assets, liabilities, equity, revenue, expenses;

- Whether there are items on which the attention of the users of the particular entity’s financial statements tends to be focused

**Example**

For the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets
The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

The entity’s ownership structure and the way it is financed and financed and

**Example**

If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity’s earnings;

The relative volatility of the benchmark.

12.1.2 Examples of appropriate benchmarks depending on entity’s circumstances

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as:

♦ profit before tax,
♦ total revenue,
♦ gross profit and total expenses,
♦ total equity or net asset value.

Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
12.1.3 Chosen Benchmark – Relevant financial data

In relation to the chosen benchmark, relevant financial data ordinarily includes –

♦ prior periods’ financial results and financial positions,
♦ the period to-date financial results and financial position, and
♦ budgets or forecasts for the current period,
♦ adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates.

*Example*

When, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

12.1.4 Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment.

There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

*Example*

The auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

12.2 Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:
1. Whether law, regulations or the applicable financial reporting framework affect users’ expectations regarding the measurement or disclosure of certain items.

*Example*

Related party transactions, and the remuneration of management and those charged with governance.

2. The key disclosures in relation to the industry in which the entity operates.

*Example*

Research and development costs for a pharmaceutical company.

3. Whether attention is focused on a particular aspect of the entity’s business that is separately disclosed in the financial statements.

*Example*

A newly acquired business.

**12.3 Revision in Materiality level as the Audit Progresses**

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity’s business), new information, or a change in the auditor’s understanding of the entity and its operations as a result of performing further audit procedures.

*Example*

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.
12.4 Documenting the Materiality

The audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole;
(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;
(c) Performance materiality; and
(d) Any revision of (a)-(c) as the audit progressed.

**SUMMARY**

After establishment of the overall audit strategy, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor’s resources.

In establishing the overall audit strategy, the auditor shall:

- Identify the scope of the engagement
- Ascertain the reporting objectives of the engagement
- Consideration of significant factors in directing the engagement team’s efforts
- Consider the results of preliminary engagement activities
- Ascertain the nature, timing and extent of resources required for the engagement

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

**Development of an Overall Plan:**

- The terms of his engagement and statutory responsibilities.
- Nature and timing of reports
- Applicable legal or statutory requirements.
- Accounting policies adopted by the client
- Effect of new accounting or auditing pronouncements on the audit.
- Identification of significant audit areas.
Setting of materiality levels for audit purposes.
- The degree of reliance on accounting system and internal control
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement
- The involvement of other auditors
- The involvement of experts.
- The allocation of work between joint auditors
- Establishing and coordinating staffing requirements.

The auditor shall document (a) the overall audit strategy; (b) the audit plan; and (c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

**AN AUDIT PROGRAMME** is a detailed plan and consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For framing an audit programme the following points should be kept in view:

SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether
**TEST YOUR KNOWLEDGE**

**MCQs**

1. The audit plan is ___________ detailed than the overall audit strategy
   (a) Less
   (b) More
   (c) Equal

2. Planning is _____ process of an audit that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement:
   (a) continuous
   (b) discreet
   (c) neither continuous nor discreet

3. The auditor shall develop an audit plan that shall include a description of:
   (a) the nature, timing and extent of planned risk assessment procedure
   (b) The nature, timing and extent of planned further audit procedures at the assertion level.
   (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

4. With reference to SA 300, the auditor shall document:
   (a) The overall audit strategy
   (b) The audit plan
   (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
   (d) All of the above

5. The overall audit strategy and the audit plan remain the ______ responsibility
   (a) auditor’s
   (b) management’s
   (c) those charged with governance
6. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of ________

(a) Independence
(b) Professional judgement
(c) Professional skepticism
(d) All of the above

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

1. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.

2. Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.

3. Planning is a discrete phase of an audit

4. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) does not need any revision.

Theoretical Questions

1. “Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy”. Explain.

2. “Planning is not a discrete phase of an audit, but rather a continual and iterative process”. Discuss.

3. “The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors.” Explain.

4. “The utility of the audit programme can be retained and enhanced only by keeping the programme and also the client’s operations and internal control
under periodic review so that inadequacies or redundancies of the programme may be removed’. Discuss stating clearly the advantages of an audit programme.

5. “Determining materiality involves the exercise of professional judgment”. Discuss stating the factors that may affect the identification of an appropriate benchmark. Also give example.

**ANSWERS/SOLUTIONS**

**Answers to MCQs.**

1. (b) 2. (a) 3. (d) 4. (d) 5. (a) 6. (b)

**Answers to Correct/Incorrect**

1. Correct: Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor’s resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

2. Incorrect. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

3. Incorrect. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

4. Incorrect: Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity’s business), new information, or a change in the auditor’s understanding of the entity and its operations as a result of performing further audit procedures.
Hints to Theoretical Questions

1. Refer para 3
2. Refer para 5
3. Refer para 8
4. Refer para 10
5. Refer para 12
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concepts of audit documentation, nature and purpose of audit documentation, Form, content and extent of audit documentation, audit documentation summary, audit file, assembly of the final audit file, ownership of audit documentation, nature of related party relationships and transactions.

- Gain the knowledge of written representations and the objectives of the auditor regarding written representation.

- Identify Audit Evidence—Specific Considerations For Selected Items, External confirmation.

- Learn objective of Auditor with respect to Opening balances – in conducting an initial audit engagement.

- Explain audit evidence, sufficiency and appropriateness of audit evidence, types of audit evidence, relevance and reliability of audit evidence, and also methods to obtain audit evidence.

- Understand materiality, its definition and judge the materiality of the item in different circumstances.

- Explain concepts of true and fair and disclosure of accounting policies.

- Understand the Fundamental Accounting Assumptions.
1. Audit documentation: SA 230 on “Audit Documentation”, audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as “working papers” or “work papers” are also sometimes used.)

1.1 Nature of Audit Documentation

Audit documentation provides:

(a) evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

1.2 Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.
1.3 Form, Content and Extent of Audit Documentation

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

1.4 Examples of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media.

Example

<table>
<thead>
<tr>
<th>Audit Documentation include:</th>
</tr>
</thead>
<tbody>
<tr>
<td>♦ Audit programmes.</td>
</tr>
<tr>
<td>♦ Analyses.</td>
</tr>
<tr>
<td>♦ Issues memoranda.</td>
</tr>
<tr>
<td>♦ Summaries of significant matters.</td>
</tr>
<tr>
<td>♦ Letters of confirmation and representation.</td>
</tr>
<tr>
<td>♦ Checklists.</td>
</tr>
<tr>
<td>♦ Correspondence (including e-mail) concerning significant matters.</td>
</tr>
</tbody>
</table>

The auditor may include copies of the entity’s records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity’s accounting records.

1.5 Audit File

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
1.6 Assembly of the Final Audit File

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report.

SQC 1 “Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services”, requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.

The completion of the assembly of the final audit file after the date of the auditor’s report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor’s report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor’s report, or, if later, the date of the group auditor’s report.

1.7 Documentation of Significant Matters and Related Significant Professional Judgments

Judging the significance of a matter requires an objective analysis of the facts and circumstances.
Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor’s previous assessment of the risks of material misstatement and the auditor’s responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor’s report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor’s conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor’s conclusion when a requirement provides that the auditor ‘shall consider’ certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor’s conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor’s conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
1.8 **Completion Memorandum or Audit Documentation Summary**

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- the significant matters identified during the audit and
- how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor’s consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

1.9 **Ownership of Audit Documentation**

Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

2. **AUDIT EVIDENCE**

2.1 **Introduction**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.
AUDIT DOCUMENTATION AND AUDIT EVIDENCE

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor’s rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

2.2 Sufficiency and Appropriateness of Audit Evidence

Audit evidence is necessary to support the auditor’s opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity’s accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management’s expert. Audit evidence comprises both information that supports and corroborates management’s assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management’s refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and
analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

**Sufficiency of Audit Evidence:** Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor’s judgment as to sufficiency may be affected by the factors such as:**

(i) **Materiality**

(ii) **Risk of material misstatement**

(iii) **Size and characteristics of the population.**

(a) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(2) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity’s internal control. Less evidence would be required in case assertions that have
AUDIT DOCUMENTATION AND AUDIT EVIDENCE

a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(c) Size of a population refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence: Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330, “The Auditor’s Responses to Assessed Risks” requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgement. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

In order to obtain reliable audit evidence, information produced by the entity (“IPE”) that is used for performing audit procedures needs to be sufficiently complete and accurate.

2.3 Sources of Audit Evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

Example

- through analysis and review,
- reperforming procedures followed in the financial reporting process,
- and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.
More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

**Example**

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts’ reports, and comparable data about competitors.

### 2.4 Audit Procedures to Obtain Audit Evidence

Audit evidence to draw reasonable conclusions on which to base the auditor’s opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

(i) Test of controls, when required by the SAs or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, test of controls or substantive procedures, depending on the context in which they are applied by the auditor.

**Risk assessment procedures** refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

**Nature and Timing of the Audit Procedures**

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source
documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity’s data retention policies to request retention of some information for the auditor’s review or to perform audit procedures at a time when the information is available.

**Audit Procedures**

Audit procedures to obtain audit evidence can include:

(i) Inspection
(ii) Observation
(iii) External Confirmation
(iv) Recalculation
(v) Reperformance
(vi) Analytical Procedures
(vii) Inquiry

**Inspection**: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

**Example**

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

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Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity’s application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity’s rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

**Observation:** Observation consists of looking at a process or procedure being performed by others.

**Example**

The auditor’s observation of inventory counting by the entity’s personnel, or of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

**External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

**Example**

The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

**Example**

The absence of a “side agreement” that may influence revenue recognition.

**Recalculation:** Recalculation consists of checking the mathematical accuracy of
documents or records. Recalculation may be performed manually or electronically.

**Re-performance:** Re-performance involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.

**Example**

Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

**Analytical Procedures:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

*(Note: Students are advised to refer Chapter 8 Analytical Procedures for detailed understanding of the concept)*

**Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management’s intent may be limited. In these cases, understanding management’s past history of carrying out its stated intentions, management’s stated reasons for choosing a particular course of action, and management’s ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.
At this stage, it would be pertinent to discuss further audit procedures, which comprise:

(i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

**Test of controls:** Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

**Nature and Extent of Test of Controls**

In designing and performing test of controls, the auditor shall:

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

   (i) How the controls were applied at relevant times during the period under audit.

   (ii) The consistency with which they were applied.

   (iii) By whom or by what means they were applied.

(b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.
Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

**Timing of Test of Controls**

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor’s intended reliance.

Audit evidence pertaining only to a point in time may be sufficient for the auditor’s purpose, for example, when testing controls over the entity’s physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity’s monitoring of controls.

**Using Audit Evidence Obtained in Previous Audits**

In determining whether it is appropriate to use audit evidence about the operating
effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

(a) The effectiveness of other elements of internal control, including the control environment, the entity’s monitoring of controls, and the entity's risk assessment process;

(b) The risks arising from the characteristics of the control, including whether it is manual or automated;

(c) The effectiveness of general IT-controls;

(d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

(e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

(f) The risks of material misstatement and the extent of reliance on the control.

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

**Evaluating the Operating Effectiveness of Controls**

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

A material misstatement detected by the auditor’s procedures is a strong indicator of the existence of a significant deficiency in internal control.

**Specific inquiries by auditor when deviations from controls are detected.**

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:
(a) The test of controls that have been performed provide an appropriate basis for reliance on the controls;
(b) Additional test of controls are necessary; or
(c) The potential risks of misstatement need to be addressed using substantive procedures.

**Substantive Procedures**

Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures), and

(ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:

---

**Designing and Performing Substantive Procedures**

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:
(i) the auditor’s assessment of risk is judgmental and so may not identify all risks of material misstatement; and
(ii) there are inherent limitations to internal control, including management override.

2. Depending on the circumstances, the auditor may determine that:
   (i) Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor’s assessment of risk is supported by audit evidence from test of controls.
   (ii) Only tests of details are appropriate.
   (iii) A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, “Analytical Procedures” establishes requirements and provides guidance on the application of analytical procedures during an audit.

4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.

6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

**External Confirmation as Substantive Procedures**

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

1. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not
be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

(i) Bank balances and other information relevant to banking relationships.
(ii) Accounts receivable balances and terms.
(iii) Inventories held by third parties at bonded warehouses for processing or on consignment.
(iv) Property title deeds held by lawyers or financiers for safe custody or as security.
(v) Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
(vi) Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
(vii) Accounts payable balances and terms.

2. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence.

Example

External confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

3. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters.

Example

For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions.
Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.

4. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

(i) The confirming party’s knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.

(ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:

- may not accept responsibility for responding to a confirmation request;
- may consider responding too costly or time consuming;
- may have concerns about the potential legal liability resulting from responding;
- may account for transactions in different currencies; or
- may operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

(iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

**Substantive Procedures Related to the Financial Statement Closing Process**

The auditor’s substantive procedures shall include the following audit procedures related to the financial statement closing process:

(a) Agreeing or reconciling the financial statements with the underlying accounting records; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature, and also the extent, of the auditor’s examination of journal entries and
other adjustments depends on the nature and complexity of the entity’s financial reporting process and the related risks of material misstatement.

**Substantive Procedures Responsive to Significant Risks:** When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. The above paragraph requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.

**Example**

If the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

**The Use of Assertions**

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

(a) Assertions about classes of transactions and events for the period under audit:

(i) **Occurrence** – transactions and events that have been recorded have occurred and pertain to the entity.

(ii) **Completeness** – all transactions and events that should have been recorded have been recorded.

(iii) **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) **Cut-off** – transactions and events have been recorded in the correct accounting period.

(v) **Classification** – transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

(i) **Existence** – assets, liabilities, and equity interests exist.

(ii) **Rights and obligations** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) **Valuation and allocation** – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

(i) **Occurrence and rights and obligations** – disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) **Completeness** – all disclosures that should have been included in the financial statements have been included.
(iii) **Classification and understandability** – financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) **Accuracy and valuation** – financial and other information are disclosed fairly and at appropriate amounts.

3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

4. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

**Example 1:** When we find in the balance sheet, an item under current assets reading as “cash in hand - ₹ 8,000” the obvious assertions that would strike the mind are the following:

(i) The firm concerned had ₹ 8,000 in hand in valid notes and coins on the balance sheet day;

(ii) That the cash was free and available for expenditure to the firm; and

(iii) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

**Example 2:**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant and Machinery (at cost)</td>
<td>2,00,000</td>
</tr>
<tr>
<td>Less: Depreciation till the end of previous year</td>
<td>70,00</td>
</tr>
<tr>
<td>Depreciation for the year</td>
<td>13,00</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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The assertions are as follows:

(i) the firm owns the plant and machinery;
(ii) the historical cost of plant and machinery is ₹ 2 lacs;
(iii) the plant and machinery physically exists;
(iv) the asset is being utilised in the business of the company productively;
(v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and
(vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements. Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

(i) the name of the lender, if it is relevant;
(ii) the nature of security provided; and
(iii) the rate at which interest is payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as “building”, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present “the results of operations” a balance sheet purports to present “financial position”. The auditor’s opinion is typically directed to these
overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgments of these specific assertions he arrives at a judgement on the financial statement as a whole.

Some observations about audit evidence may be of help in deciding upon the techniques to be adopted for obtaining them. First, there is nothing mysterious about the evidence which an auditor can obtain and on which he relies; it is straightforward information, some of it is obtained only by diligent effort but all of it is of the common sense variety. Second, evidence varies in reliability. When the auditor recalculates certain figures, like depreciation or inventory valuation, he may be completely convinced about the reliability of the company’s figure. However, information supplied by an employee may not be that reliable because he may have an interest in concealing rather than revealing the truth. This suggests that we must always be alert to the relative reliability of different kinds of evidence. Third, some evidence may be more difficult to obtain than other. It is relatively easy to put questions to employees who are present inside the company. It is easy to examine inventory on hand; it is more difficult to verify inventory stored elsewhere. Fourth, it must be recognised that the available evidence be persuasive and that the evidence may not be conclusive. In giving the opinion, the auditor necessarily takes a calculated risk. He gets the best evidence reasonably available and forms his judgment accordingly. In fact, in auditing it is very difficult and at times impracticable to obtain conclusive evidence both on account of time and cost constraints. This explains why an auditor gives an opinion rather than some kind of guarantee or certificate. All he can state is that he has carefully examined the various assertions in the financial statements, obtained evidence what he, in his professional judgement, thought adequate or the best available; and that he has considered that evidence judiciously in forming an opinion as to the reliability of the financial statements. Fifth, the auditor may gain increased assurance when audit evidence obtained from different sources of a different nature is consistent. In the circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely when audit evidence obtained from one source is inconsistent with that obtained from another, further procedure may have to be performed to resolve the inconsistency. Sixth, the auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated. Seventh, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the
matters of difficulty and expenses involved in testing a particular item is not in itself a valid basis for omitting a procedure. Eight, when the auditor is in reasonable doubt as to any assertion he should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should not express an unqualified opinion.

2.5 Types of Audit Evidence

Internal evidence and external evidence: Evidence which originates within the organisation being audited is internal evidence.

**Example**

Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client’s organization.

**Example**

Purchase invoice, supplier’s challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties.
who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidence corroborate each other.

2.6 Relevance and Reliability

While audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources.

Example

Previous audits, in certain circumstances, and a firm’s quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance: Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Example

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers’ statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to
the same assertion.

Test of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing test of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

**Reliability:** The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management’s expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a
3.29

AUDIT DOCUMENTATION AND AUDIT EVIDENCE

contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

♦ Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

3. WRITTEN REPRESENTATIONS

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

3.1 Written Representations as Audit Evidence

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity’s financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management’s responsibilities, or

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about specific assertions.

**ILLUSTRATION**

The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker’s certificate in support of Fixed deposits whereas management provides only written representation on the matter.

**Required**

Discuss how would you deal as an auditor.

**SOLUTION**

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management’s responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker’s certificate in support of fixed deposits held by the company.

**3.2 The objectives of the auditor regarding written representation**

The objectives of the auditor are:

(a) **To obtain written representations**

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) **To support other evidence**

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) **To respond appropriately**

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.
3.3 Management from Whom Written Representations Requested

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

Written representations may therefore be requested from the entity’s chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity’s business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

♦ An actuary responsible for actuarially determined accounting measurements.
♦ Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
♦ Internal counsel who may provide information essential to provisions for legal claims.

In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
3.4 Written Representations about Management’s Responsibilities

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements.

Audit evidence obtained during the audit that management has fulfilled the responsibilities is not sufficient without obtaining confirmation from management about the same. This is because the auditor is not able to judge solely on other audit evidence.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

4. Audit Evidence — Specific Considerations for Selected Items

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

(a) Existence and condition of inventory;
(b) Completeness of litigation and claims involving the entity; and
(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.
4.1 Inventory
When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(a) Attendance at physical inventory counting, unless impracticable, to:
   (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;
   (ii) Observe the performance of management’s count procedures;
   (iii) Inspect the inventory; and
   (iv) Perform test counts.
(b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

4.2 Attendance at Physical Inventory Counting
Attendance at Physical Inventory Counting Involves:

(a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
(b) Observing compliance with management’s instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
(c) Obtaining audit evidence as to the reliability of management’s count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor’s risk assessment, planned approach and the specific procedures carried out.

4.3 Matters Relevant in Planning Attendance at Physical Inventory Counting
Matters relevant in planning attendance at physical inventory counting include, for example:

(a) Nature of inventory.
(b) Stages of completion of work in progress.
(c) The risks of material misstatement related to inventory.
(d) The nature of the internal control related to inventory.
(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
(f) The timing of physical inventory counting.
(g) Whether the entity maintains a perpetual inventory system.
(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
(i) Whether the assistance of an auditor’s expert is needed.

4.4 Physical Inventory Counting Conducted Other than at the Date of the Financial Statements

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

4.5 If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

4.6 Attendance at Physical Inventory Counting Is Impracticable

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705.

In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as
explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

ILLUSTRATION

Paramount Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of Paramount Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

SOLUTION

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
3.6 AUDITING AND ASSURANCE

(b) Perform inspection or other audit procedures appropriate in the circumstances.

4.7 Litigation and Claims

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

4.8 If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity’s External Legal Counsel

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity’s external legal counsel.

The auditor shall do so through a letter of inquiry requesting the entity’s external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity’s external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

In certain circumstances, the auditor also may judge it necessary to meet with the entity’s external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

♦ The auditor determines that the matter is a significant risk.
♦ The matter is complex.
♦ There is disagreement between management and the entity’s external legal counsel. Ordinarily, such meetings require management’s permission and are held with a representative of management in attendance.
ILLUSTRATION

Pride India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

SOLUTION

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity’s external legal counsel.

5. EXTERNAL CONFIRMATION

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

5.1 Definition of other Important Terms

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.

The exception need to be assessed to the entire population after analyzing the reason for difference.

5.2 External Confirmation Procedures

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

5.3 Determining the Information to be Confirmed or Requested

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a “side agreement”.

5.4 Designing Confirmation Requests

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

Factors to consider when designing confirmation requests include:

♦ Specific identified risks of material misstatement, including fraud risks.

♦ The layout and presentation of the confirmation request.

♦ Prior experience on the audit or similar engagements.

♦ The assertions being addressed.
AUDIT DOCUMENTATION AND AUDIT EVIDENCE

♦ The method of communication [for example, in paper form, or by electronic mode (like e-mail) or other medium].

♦ Management’s authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation.

♦ The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

5.5 Management’s Refusal to Allow the Auditor to Send a Confirmation Request

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(a) Inquire as to management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor’s opinion in accordance with SA 705.

ILLUSTRATION

While conducting the audit of Jay Kay Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?
SOLUTION

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(a) Inquire as to management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor’s opinion in accordance with SA 705.

6. INITIAL AUDIT ENGAGEMENT

An engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

6.1 Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period’s financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.
6.2 Audit Procedures regarding Opening Balances

The auditor shall read the most recent financial statements, if any, and the predecessor auditor’s report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period’s financial statements by:

(a) Determining whether the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year’s Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:
   
   (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

   (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

   (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period’s financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period’s financial statements. If the auditor concludes that such misstatements exist in the current period’s financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450.

6.3 Consistency of Accounting Policies relating to opening balances

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, and whether changes in the
accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.4 Audit Conclusions and Reporting in relation to Opening Balances

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

If the auditor concludes that the opening balances contain a misstatement that materially affects the current period’s financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

7. MEANING OF RELATED PARTY

A party that is either:

(i) A related party as defined in the applicable financial reporting framework; or

(ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:

   (a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

   (b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

   (c) Another entity that is under common control with the reporting entity through having:

       ➢ Common controlling ownership;
       ➢ Owners who are close family members; or
       ➢ Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.
7.1 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

7.2 Responsibilities of the Auditor

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity’s failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity’s related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

(a) Achieve a true and fair presentation; or

(b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity’s related party relationships and transactions is relevant to the auditor’s evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.
Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

♦ Management may be unaware of the existence of all related party relationships.
♦ Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

8. CONCEPT OF TRUE AND FAIR

The concept of true and fair is a fundamental concept in auditing. The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

**SA 700 “Forming an Opinion and Reporting on Financial Statements”, requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Accounting Standards.**

What constitutes a ‘true and fair’ view is a matter of an auditor’s judgment in the
particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

(i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
(ii) no material asset is omitted;
(iii) the charge, if any, on assets are disclosed;
(iv) material liabilities should not be omitted;
(v) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
(vi) accounting policies have been followed consistently; and
(vii) all unusual, exceptional or non-recurring items have been disclosed separately.

9. AUDITOR AND THE SUBSEQUENT EVENTS

Meaning of Subsequent Events

Events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report.

Objectives

The objectives of the auditor are to:

(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and
(b) Respond appropriately to facts that become known to the auditor after the date of the auditor’s report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor’s report.
Audit Procedure Regarding Events Occurring between the Date of the Financial Statements and the Date of the Auditor’s Report

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

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor’s report, or as near as practicable thereto. The auditor shall take into account the auditor’s risk assessment which shall include the following:
(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings of the entity’s owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity’s latest subsequent interim financial statements, if any.

When, as a result of the procedures performed as required above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

**Auditor’s Obligations Regarding Subsequent Events**

**I** Facts which become known to the auditor after the date of the auditor’s report but before the date the financial statements are issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor’s report. However, when, after the date of the auditor’s report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor’s report, may have caused the auditor to amend the auditor’s report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.
(II) Facts Which Become Known to the Auditor After the Financial Statements have been Issued

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor’s report, may have caused the auditor to amend the auditor’s report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

10. AUDITOR AND THE GOING CONCERN ASSUMPTION

Going Concern Basis of Accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is
AUDIT DOCUMENTATION AND AUDIT EVIDENCE

appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern

The objectives of the auditor are:

(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Responsibilities of the Auditor

The auditor’s responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity’s ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor’s ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity’s ability to continue as a going concern in an auditor’s report cannot be viewed as a guarantee as to the entity’s ability to continue as a going concern.

Events or Conditions That May Cast Significant Doubt on the Entity’s Ability to Continue as a Going Concern

The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.
Financial
- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.

Operating
- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other
- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

Additional Audit Procedures When Events or Conditions Are Identified
If events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern (hereinafter referred to as “material
uncertainty”) through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(a) Where management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management’s plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management’s plans are feasible in the circumstances.

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future actions:
   (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
   (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management regarding their future action plans and the feasibility of these plans.

Audit procedures that are relevant to the requirement as stated above may include the following:

♦ Analyzing and discussing cash flow, profit and other relevant forecasts with management.

♦ Analyzing and discussing the entity’s latest available interim financial statements.

♦ Reading the terms of debentures and loan agreements and determining whether any have been breached.

♦ Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

♦ Inquiring of the entity’s legal counsel regarding the existence of litigation and claims and the reasonableness of management’s assessments of their outcome and the estimate of their financial implications.
♦ Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.

♦ Evaluating the entity’s plans to deal with unfilled customer orders.

♦ Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity’s ability to continue as a going concern.

♦ Confirming the existence, terms and adequacy of borrowing facilities.

♦ Obtaining and reviewing reports of regulatory actions.

♦ Determining the adequacy of support for any planned disposals of assets.

**SUMMARY**

Audit documentation (SA 230) refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation provides evidence of the auditor’s basis for a conclusion and evidence that the audit was planned and performed in accordance with SAs. Audit file refers to one or more folders or other storage media containing the records that comprise the audit documentation for a specific engagement.

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

As explained in SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

Risk assessment procedures refer to the audit procedures performed to obtain an...
understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity’s external legal counsel.

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period’s financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity’s failure to appropriately account for related party relationships, transactions or balances.

The concept of true and fair is a fundamental concept in auditing. The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

Events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the
The auditor’s responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity’s ability to continue as a going concern.

**TEST YOUR KNOWLEDGE**

**MCQs**

1. __________refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.
   (a) Audit Techniques
   (b) Audit evidence
   (c) Audit Documentation
   (d) None of the above

2. __________may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
   (a) Audit File
   (b) Audit evidence
   (c) Completion Memorandum
   (d) both (a) and (b) above

3. As per SQC-1 “An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than ______days after the date of the auditor’s report”.
   (a) 30
   (b) 60
   (c) 90
   (d) 45

4. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
   (a) Positive confirmation request

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(b) Non Response
(c) Negative Confirmation request
(d) Exception

5. Auditor’s judgment as to sufficiency may be affected by which factor:
   (a) Materiality
   (b) Risk of material misstatement
   (c) Size and characteristics of the population.
   (d) All of the above

6. Which of the following is not an Audit procedures to obtain audit evidence:
   (a) Inspection
   (b) Observation
   (c) External Confirmation
   (d) None of the above

7. Which of the following is not an assertion about presentation and disclosure:
   (a) Occurrence and rights and obligations
   (b) Completeness
   (c) Classification and understandability
   (d) Existence

Correct/Incorrect
State with reasons (in short) whether the following statements are correct or incorrect:
(i) As per SA 230 on “Audit Documentation”, the working papers are not the property of the auditor.
(ii) Purchase invoice is an example of internal evidence.
(iii) Sufficiency is the measure of the quality of audit evidence.

Theoretical Questions
1. Define audit documentation. Also give some examples.
2. “Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits”. Explain.
3. “Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal”. Discuss.

4. Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

5. Define Risk of material misstatement. Explain its components also.

6. “When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences” Explain.

ANSWERS/SOLUTIONS

Answers to MCQs
1. (c) 2. (a) 3. (b) 4. (c) 5. (d) 6. (d)

Answers to Correct/Incorrect
(i) Incorrect: As per SA 230 on “Audit Documentation” the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

(ii) Incorrect: Internal evidence is the evidence that originates within the client’s organisation. Since purchase invoice originates outside the client’s organisation, therefore, it is an example of external evidence.

(iii) Incorrect: Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

Answers to Theoretical Questions
1. Refer Para 1.4
2. Refer Para 1.8
3. Refer Para 3.1
4. Refer Para 6.1
5. Refer Para 2.2
6. Refer Para 2.4
After studying this chapter, you will be able to:

- Audit Risk, Risk of Material Misstatement and its Components.
- Risk Assessment Procedures.
- The Entity and Its Environment, Including the Entity’s Internal Control.
- Concept of Internal Control, Components of Internal Control and Controls relevant to Audit.
- Identify Significant Risks.
1. **AUDIT RISK**

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Audit risk is a function of the risks of material misstatement and detection risk.

From the above, it is clear that –

\[
\text{Audit Risk} = \text{Risk of Material Misstatement} \times \text{Detection Risk} \tag{1}
\]

**Note 1:** Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(a) **Inherent risk**—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(b) **Control risk**—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

**Note 2:** Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

### 1.1 Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

### 1.2 What is not included in Audit Risk?

(i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.
Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor’s business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

### 1.3 Risks of Material Misstatement at Two levels

The risks of material misstatement may exist at two levels:

| (i) | The overall financial statement level- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. |
| (ii) | The assertion level for classes of transactions, account balances, and disclosures- Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. |

### 1.4 Components of Risk of Material Misstatement

The risks of material misstatement at the assertion level consist of two components:

(i) Inherent risk and

(ii) Control risk.

Inherent risk and control risk are the entity’s risks; they exist independently of the audit of the financial statements.

Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Inherent risk factors are considered while designing tests of controls and substantive procedures. Category of auditor’s assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower. It is important to consider the reason for each identified inherent risk even if the risk is
lower, when auditor designs tests of controls and substantive procedures.

**Example**

A lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

**Control risk** is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

**Example**

The possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

The SAs provide the conditions under which the auditor is required to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

**Auditor assesses control risk as Rely or Not rely on Controls.** When making control risk assessments, consider:

- The control environment’s influence over internal control. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity. However it does not guarantee the effectiveness of specific controls. We therefore, test the operating effectiveness of controls over significant class of transactions (SCOTs) when we plan to take a controls reliance strategy. Conversely, the control environment may undermine the effectiveness of specific controls and is a key factor in our control risk assessments.

- Evaluations of the related IT processes that support application and IT-dependent manual controls.

- Our testing approach over SCOTs and disclosure processes (i.e., controls reliance or substantive only strategy).

- The expectation of the operating effectiveness of controls based on the understanding of entity’s processes.
Example

Identify a control that a shipping report is prepared only for goods that have been shipped. To determine that only sales that have occurred are recorded, identify a further control that sales cannot be recorded unless a shipping report is produced. In this example, several controls operate collectively in order to address the occurrence assertion for sales.

In another example, a regular reconciliation of quantities shipped to quantities billed is a specific control that may be effective enough by itself to address the WCGW (What Could Go Wrong) regarding the completeness assertion in a sales process.

Whether several controls are required to operate collectively (i.e., a suite of controls) to achieve a financial reporting objective. If so, the auditor should assess whether all controls operate effectively in order to rely on controls.

Control risk assessment when control deficiencies are identified: When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a ‘rely on controls’ risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the ‘rely on controls’ is still appropriate. Otherwise we change our control risk assessment to ‘not rely on controls.’

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to ‘not rely on controls’ for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW’s, he can ‘rely on controls’ but performs additional substantive procedures to adequately address the risks related to the deficiency.

1.5 Combined Assessment of the Risk of Material Misstatement

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be
expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that-

<table>
<thead>
<tr>
<th>Risk of Material Misstatement = Inherent Risk x Control Risk -----(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>From (1) and (2), we arrive at-</td>
</tr>
<tr>
<td><strong>Audit Risk = Inherent Risk x Control Risk x Detection Risk</strong></td>
</tr>
</tbody>
</table>

SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

### 1.6 Detection Risk

**Detection risk:** The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

**ILLUSTRATION**

*XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.*

Discuss the types of inherent, control and detection risks as perceived by the auditor.

**SOLUTION**

**Inherent Risk:** Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

**Control Risk:** There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

**Detection Risk:** Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.
2. IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Objective of Auditor as per SA 315: As per SA 315 - “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Let us understand the objective of the auditor as stated in SA 315 in detail.

2.1 Identify and assess the risks of material misstatement

(i) The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level

(b) the assertion level for classes of transactions, account balances, and disclosures

to provide a basis for designing and performing further audit procedures

(ii) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.
2.1.1 Risk Assessment Procedures

**Definition:** The audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

**Risk assessment procedure - a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels**

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

**Information obtained by performing risk assessment procedures - Used as audit evidence**

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

**The risks to be assessed include both those due to error and those due to fraud**

The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. (Fraud risk is discussed in detail in Chapter 5 Fraud and Responsibilities of an Auditor in this regard).
What is included in Risk Assessment Procedures?

The risk assessment procedures shall include the following:

| (a) | Inquiries of management and of others within the entity who in the auditor’s judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. |
| (b) | Analytical procedures. |
| (c) | Observation and inspection. |

(a) **Inquiries of Management and Others Within the Entity:** Much of the information obtained by the auditor’s inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

**Example**

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.

- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity’s internal control and whether management has satisfactorily responded to findings from those procedures.

- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.

- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.

- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity’s marketing strategies, sales trends, or contractual arrangements with its customers.
Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.

Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

(b) **Analytical Procedures**: Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

(c) **Observation and Inspection**: Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

*Example*

Examples of such audit procedures include observation or inspection of the following:

<table>
<thead>
<tr>
<th>The entity’s operations.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Documents (such as business plans and strategies), records, and internal control manuals.</td>
</tr>
</tbody>
</table>

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RISK ASSESSMENT AND INTERNAL CONTROL

Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director’s meetings)

The entity’s premises and plant facilities.

2.2 UNDERSTANDING OF THE ENTITY- A CONTINUOUS PROCESS

Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an “understanding of the entity”), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

♦ Assessing risks of material misstatement of the financial statements;
♦ Determining materiality in accordance with SA 320;
♦ Considering the appropriateness of the selection and application of accounting policies;
♦ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management’s use of the going concern assumption, or considering the business purpose of transactions;
♦ Developing expectations for use when performing analytical procedures;
♦ Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management’s oral and written representations.

ILLUSTRATION

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity’s business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

SOLUTION

Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an “understanding of the entity”), is a continuous, dynamic process of gathering, updating and analysing information.
throughout the audit. The auditor should proceed accordingly.

### 2.3 The Required Understanding of the Entity and Its Environment, Including the Entity’s Internal Control

The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

(b) The nature of the entity, including:

   (i) its operations;
   (ii) its ownership and governance structures;
   (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   (iv) the way that the entity is structured and how it is financed;

   to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity’s financial performance.

**ILLUSTRATION**

*Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.*

**SOLUTION**

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.
3. INTERNAL CONTROL

Meaning of Internal Control

As per SA-315, “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, the internal control may be defined as “the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.”

Objectives of Internal Control

(i) transactions are executed in accordance with managements general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorised access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

The Entity’s Internal Control

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures.
ILLUSTRATION

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

SOLUTION

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Study of various aspects of internal control is divided into four sections, as follows:

(I) General Nature and Characteristics of Internal Control

Purpose of Internal Control: Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity’s objectives that concern:

♦ The reliability of the entity’s financial reporting;
♦ The effectiveness and efficiency of its operations;
♦ Its compliance with applicable laws and regulations; and
♦ Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity’s size and complexity.

Limitations of Internal Control

(i) Internal control can provide only reasonable assurance:

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting.
objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) **Human judgment in decision-making:**
Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

*Example*

There may be an error in the design of, or in the change to, a control.

(iii) **Lack of understanding the purpose:**
Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) **Collusion among People:**
Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity’s standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) **Judgements by Management:**
Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) **Limitations in case of Small Entities:**
Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken
into account by the auditor when identifying the risks of material misstatement due to fraud.

(II) Controls Relevant to the Audit

There is a direct relationship between an entity’s objectives and the controls it implements to provide reasonable assurance about their achievement. The entity’s objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor’s risk assessment.

Factors relevant to the auditor’s judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity’s business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity’s operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity’s internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Controls over the completeness and accuracy of information

Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.
Internal control over safeguarding of assets

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor’s consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Controls relating to objectives that are not relevant to an audit

An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline’s system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity’s operating units and business processes may not be relevant to the audit.

The statute may require the auditor to report on compliance with certain internal controls

In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor’s review of internal control may be broader and more detailed.

(III) Nature and Extent of the Understanding of Relevant Controls.

(i) Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first

An improperly designed control may represent a significant deficiency in internal control.
(ii) Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

(iii) Obtaining an understanding of an entity’s controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls.

**Example**

Obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control’s operating effectiveness, depending on the auditor’s assessment and testing of controls such as those over program changes.

**IV) Components of Internal Control**

The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity’s internal control may affect the audit:

(A) The control environment;
(B) The entity’s risk assessment process
(C) The information system, including the related business processes, relevant to financial reporting, and communication
(D) Control activities
(E) Monitoring of controls.

(A) **Control Environment— Component of Internal Control**— The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**What is included in Control Environment?**

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

**Elements of the Control Environment**—Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) **Communication and enforcement of integrity and ethical values**—These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) **Commitment to competence**—Matters such as management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) **Participation by those charged with governance**—Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) **Management’s philosophy and operating style**—Characteristics such as management’s:
Approach to taking and managing business risks.

Attitudes and actions toward financial reporting.

Attitudes toward information processing and accounting functions and personnel.

(e) Organisational structure— The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) Assignment of authority and responsibility— Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) Human resource policies and practices— Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

(B) The Entity’s Risk Assessment Process— Component of Control Environment

The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;
(b) Estimating the significance of the risks;
(c) Assessing the likelihood of their occurrence; and
(d) Deciding about actions to address those risks.

The entity’s risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assists the auditor in identifying risks of material misstatement. Whether the entity’s risk assessment process is appropriate to the circumstances is a matter of judgment.

(C) The information system, including the related business processes, relevant to financial reporting and communication— Component of Control Environment

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:

(a) The classes of transactions in the entity’s operations that are significant to the financial statements;
RISK ASSESSMENT AND INTERNAL CONTROL

(b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;

(d) How the information system captures events and conditions that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity’s financial statements;

(f) Controls surrounding journal entries.

<table>
<thead>
<tr>
<th>Communicating Financial Roles and Responsibilities— Obtaining an Understanding by the Auditor:</th>
<th>The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities including:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Communications between management and those charged with governance; and</td>
<td>(b) External communications, such as those with regulatory authorities.</td>
</tr>
</tbody>
</table>

The following points need consideration in this regard:

(i) **Understanding of Roles and Responsibilities:** Communication by the entity of the financial reporting roles and responsibilities would involve providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

(ii) **Understanding regarding Relation of Activities:** It includes understanding by employees as to how their activities relate to the work of others and the means of reporting exceptions to higher level within the entity.

(iii) **Policy Manuals and Financial Reporting Manuals:** Communication may take such forms as policy manuals and financial reporting manuals.

(iv) **Open Communication Channels:** Open communication channels help ensure that exceptions are reported and acted on.

(v) **Less structured and easier for Small Entities:** Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management’s greater visibility and
(D) **Control Activities– Component of Internal Control**

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

**Control activities are the policies and procedures that help ensure that management directives are carried out.**

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

**Examples of specific control activities include those relating to the following:**

![Diagram](image)

**Control activities that are relevant to the audit are:**

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- Those that are considered to be relevant in the judgment of the auditor;
- As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor’s judgment, a significant risk.

**In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:**

(a) Whether the risk is a risk of fraud;
(b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;

c) The complexity of transactions;

d) Whether the risk involves significant transactions with related parties;

e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

(Note: Student may refer Chapter 5 on for detailed understanding of Fraud Risk)

Identifying Significant Risks: Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assess assertions affected by a significant risk as higher inherent risk. The following are always significant risks:

♦ Risks of material misstatement due to fraud
♦ Significant transactions with related parties that are outside the normal course of business for the entity

Risks of Material Misstatement—Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

♦ Greater management intervention to specify the accounting treatment.
♦ Greater manual intervention for data collection and processing.
♦ Complex calculations or accounting principles.
♦ The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
Risks of material misstatement– Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

♦ Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
♦ Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

(E) Monitoring of Controls – Component of Internal Control

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

(i) Monitoring of controls Defined: Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

(ii) Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

(iii) Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

(iv) Management’s monitoring activities include: Management’s monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

(v) In case of Small Entities: Management’s monitoring of control is often accomplished by management’s or the owner-manager’s close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Monitoring of Controls– If the entity has an internal audit function

If the entity has an internal audit function, the auditor shall obtain an understanding of
RISK ASSESSMENT AND INTERNAL CONTROL

the following:

(a) The internal audit function’s responsibilities and how the internal audit function fits in the entity’s organisational structure; and

(b) The activities performed, or to be performed, by the internal audit function.

The following points merit consideration in this regard:

(i) **Internal Audit Function relevant to the Audit:** The entity’s internal audit function is likely to be relevant to the audit if its activities are related to the entity’s financial reporting. Also if the auditor expects to use the work of the internal auditors to modify the audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.

(ii) **Size and Structure of the Entity:** The objectives of an internal audit function vary widely depending on the size and structure of the entity and the requirements of management.

(iii) **Internal audit function may include:** The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations.

On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity’s financial reporting.

(iv) **External auditor’s activities- on the basis of Internal Audit activities:** If the internal audit function’s responsibilities are related to the entity’s financial reporting, the external auditor’s consideration of the activities performed may include review of the internal audit function’s audit plan for the period.

Satisfactory Control Environment – not an absolute deterrent to fraud:

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management’s failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the
nature, timing, and extent of the auditor’s further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor’s evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor’s assessment of the risks of material misstatement.

4. EVALUATION OF INTERNAL CONTROL BY THE AUDITOR

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(ii) whether an adequate internal control system is in use and operating as planned by the management;

(iii) whether an effective internal auditing department is operating;

(iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

(v) whether the controls adequately safeguard the assets;

(vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(vii) how reliable the reports, records and the certificates to the management can be;
(viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(ix) what would be appropriate audit technique and the audit procedure in the given circumstances;

(x) what are the areas where control is weak and where it is excessive; and

(xi) whether some worthwhile suggestions can be given to improve the control system.

Formulate Audit Program after understanding Internal Control

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or
other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

**Example**

Normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

**Evaluation of Internal Control—Methods**

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management.

The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company’s assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(i) Narrative record;
(ii) Check List;
(iii) Questionnaire; and
(iv) Flow chart.
4.1 The Narrative Record

This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.

The basic disadvantages of narrative records are:

(i) To comprehend the system in operation is quite difficult.
(ii) To identify weaknesses or gaps in the system.
(iii) To incorporate changes arising on account of reshuffling of manpower, etc.

4.2 A Check List

This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.

Example

A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?
The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

### 4.3 Internal Control Questionnaire

This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a ‘Yes’ answer denotes satisfactory position and a ‘No’ answer suggests weakness. Provision is made for an explanation or further details of ‘No’ answers. In respect of questions not relevant to the business, ‘Not Applicable’ reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor’s staff with the client’s employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

### 4.4 Flow Chart

It is a graphic presentation of each part of the company’s system of internal control. A flow chart is considered to be the most concise way of recording the auditor’s review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird’s eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.
5. TESTING OF INTERNAL CONTROL

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is being done by application of procedural tests and auditing in depth.

Test of Controls:

Test of controls are performed to obtain audit evidence about the effectiveness of the:

(a) design of the accounting and internal control systems, i.e., whether they are suitably designed to prevent or detect and correct material misstatements; and

(b) operation of the internal controls throughout the period.

Test of controls include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

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Test of controls may include:

♦ Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.

♦ Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.

♦ Re-performance involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

♦ Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

(Students may note that testing of IT System related controls are discussed in details in Chapter 6 Audit in an Automated Environment)

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the
prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

**Example**

<table>
<thead>
<tr>
<th>For example, the procedure for sales requires the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.</td>
</tr>
<tr>
<td>2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.</td>
</tr>
<tr>
<td>3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.</td>
</tr>
<tr>
<td>4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.</td>
</tr>
<tr>
<td>5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.</td>
</tr>
</tbody>
</table>

An auditor testing the internal controls on sales should invariably test whether any of the aforesaid procedures have been omitted. If credit has actually been granted without a reference to the credit section to know the creditworthiness of the party, it is possible that the amount may prove bad because of the financial crisis or
deadlock in the management of the party, a fact which could have been easily gathered from the credit section. Similarly, if an order is received without a reference to the inventory section, it is likely due to non-availability of the inventory on the stipulated date; execution of the order may be delayed and the company may have to compensate the buyer for the damages suffered by him.

6. INTERNAL CONTROL AND IT ENVIRONMENT

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor’s Risk Assessment: An entity’s system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements relevant to the auditor’s risk assessment and further audit procedures are explained hereunder-

(i) Controls in Manual and IT System: The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported:

(1) Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.

(2) Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.

(ii) Use of IT: An entity’s mix of manual and automated elements in internal control varies with the nature and complexity of the entity’s use of IT.

(iii) Generally, IT benefits an entity’s internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
RISK ASSESSMENT AND INTERNAL CONTROL

- Enhance the ability to monitor the performance of the entity’s activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Benefits of IT in an Entity’s Internal Control

- Processing of large volumes of transactions or data becomes simple;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity’s activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Effective segregation of duties through security controls.

(iv) IT also poses specific risks to an entity’s internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.
(v) **Suitability:** Manual elements in internal control may be more suitable where judgment and discretion are required.

(vi) **Reliability:** Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed.

(vii) **Nature of Entity’s Information System:** The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity’s information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity’s information system.

### 7. MATERIALITY AND AUDIT RISK

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor’s report.

In conducting an audit of financial statements, the overall objectives of the auditor are 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 to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:
RISK ASSESSMENT AND INTERNAL CONTROL

(a) Identifying and assessing the risks of material misstatement;
(b) Determining the nature, timing and extent of further audit procedures; and
(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor’s report.

8. DOCUMENTING THE RISK

The auditor shall document:

(a) The discussion among the engagement team and the significant decisions reached;
(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level; and
(d) The risks identified, and related controls about which the auditor has obtained an understanding.

9. INTERNAL AUDIT

As defined in scope of the Standards on Internal Audit, Internal Audit means “An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system”.

9.1 Applicability of Provisions of Internal Audit

As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

(a) every listed company;
(b) every unlisted public company having-
   (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

9.2 Who can be appointed as Internal Auditor?

As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

9.3 Internal audit function

A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.

9.3.1 The objectives and scope of internal audit functions

As per SA-610, “Using the Work of an Internal Auditor”, the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the...
entity’s governance processes, risk management and internal control such as the following:

1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.

3. **Activities Relating to Internal Control:**
   
   (i) **Evaluation of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

   (ii) **Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

   (iii) **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.
(vi) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

10. BASICS OF STANDARDS ON INTERNAL AUDIT ISSUED BY ICAI

Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit now it is known as Internal Audit Standard Board.

The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) and the list is given below. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

The following SIAs are recommendatory in nature. The Standards shall become
mandatory from such date as notified by the council:

<table>
<thead>
<tr>
<th>SIA 1: Planning an Internal Audit.</th>
<th>SIA 2: Basic Principles Governing Internal Audit</th>
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<tbody>
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<td>SIA 3: Documentation.</td>
<td>SIA 4: Reporting.</td>
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<td>SIA 5: Sampling.</td>
<td>SIA 6: Analytical Procedures.</td>
</tr>
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<td>SIA 7: Quality Assurance in Internal Audit.</td>
<td>SIA 8: Terms of Internal Audit.</td>
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<td>SIA 9: Communication with Management.</td>
<td>SIA 10: Internal Audit Evidence.</td>
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<td>SIA 11: Consideration of Fraud in an Internal Audit.</td>
<td>SIA 12: Internal Control Evaluation.</td>
</tr>
<tr>
<td>SIA 17: Consideration of Laws and Regulations in an Internal Audit.</td>
<td>SIA 18: Related Parties.</td>
</tr>
</tbody>
</table>

11. BASICS OF INTERNAL FINANCIAL CONTROL AND REPORTING REQUIREMENTS

Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

From the above definition, it is clear that internal financial controls are the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company’s policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information.”

**Auditors’ Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India**

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor’s reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

**Objectives of an auditor in an audit of internal financial controls over financial reporting:** The auditor’s objective in an audit of internal financial controls over financial reporting is, “to express an opinion on the effectiveness of the company’s internal financial controls over financial reporting.” It is carried out along with an audit of the financial statements.

**Reporting under Section 143(3)(i)** is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

**Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014** requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.
12. DIFFERENCE BETWEEN INTERNAL FINANCIAL CONTROL AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Internal Financial Control as per Section 134(5)(e), “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity’s internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

SUMMARY

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components- Inherent risk and Control risk. Inherent risk is the susceptibility of an assertion to a misstatement before consideration of any related controls. Control risk is the risk that a misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

The assessment of risks is a matter of professional judgment.

Detection risk refers to the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Audit Risk = Inherent Risk x Control Risk x Detection Risk
Objective of Auditor as per SA 315: As per SA 315 - “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

As per SA-315, “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, the internal control may be defined as “the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.”

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Selective testing is done by application of procedural tests and auditing in depth.

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on
the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor’s report.

As defined in the scope of the Standards on Internal Audit, Internal Audit means “An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system.”

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The auditor’s objective in an audit of internal financial controls over financial reporting is, “to express an opinion on the effectiveness of the company’s internal financial controls over financial reporting.” It is carried out along with an audit of the financial statements.

**TEST YOUR KNOWLEDGE**

**MCQs**

1. Audit risk is a function of the risks of material misstatement and ________
   (a) detection risk.
   (b) inherent risk
   (c) control risk
   (d) business risk

2. For a given level of audit risk, the acceptable level of detection risk bears ________relationship to the assessed risks of material misstatement at the assertion level.
   (a) direct.
   (b) Inverse
   (c) no
   (d) none of the above

3. Risk of material misstatement has ________ components
   (a) one
   (b) two
   (c) three
4. Controls can be_____ related to an assertion.
   (a) directly
   (b) indirectly
   (c) directly or indirectly
   (d) none of the above

5. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Which of the following is an example of control activities:
   (a) Authorization.
   (b) Performance reviews.
   (c) Information processing.
   (d) All of the above

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

(i) As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.

(ii) There is direct relationship between materiality and the degree of audit risk.

(iii) Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(iv) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

(v) Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Theoretical Questions

1. “The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain.
2. Risk of material misstatement consists of two components” Explain clearly defining risk of material misstatement.

3. “The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”” Explain

4. “The auditor shall obtain an understanding of the control environment” Explain stating what is included in control environment.

**ANSWERS/SOLUTIONS**

**Answers to MCQs**

1. (a) 2. (b) 3. (b) 4. (c) 5. (d)

**Answers to Correct/Incorrect**

(i) **Incorrect:** Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of `200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding `100 crore or more at any point of time during the preceding financial year.

(ii) **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

(iii) **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(iv) **Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of:

(a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and

(b) the operation of the internal controls throughout the period.
(v) **Incorrect:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity’s objectives.

### Answers to Theoretical Questions

1. Refer Para 3.
2. Refer Para 1.
3. Refer Para 1.5
4. Refer Para 3.
FRAUD AND RESPONSIBILITIES OF THE AUDITOR IN THIS REGARD

After studying this chapter, you will be able to:

- Understand the types of errors and frauds.
- Definition of fraud as given under the Standards on Auditing and its meaning.
- Understand reasons behind management/employees committing fraud/error.
- Analyse the duty of an auditor regarding detection of fraud and error.
- Determine fraud risk factors and circumstances relating to possibility of fraud.
- Understand responsibility of an auditor in case of withdrawal from the engagement if encounter any circumstances that bring into question his ability to continue due to fraud.
1. MEANING OF FRAUD

The Standard on Auditing (SA) 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” defines the term ‘fraud’ as-

“an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage”.

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned 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
♦ misstatements resulting from misappropriation of assets.
Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

2. CHARACTERISTICS OF FRAUD

2.1 Fraud is Intentional

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

2.2 Fraud is a broad legal concept

The auditor is concerned with fraud that causes a material misstatement in the financial statements.

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

♦ Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.

♦ A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

2.2.1 **Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.**

Fraudulent financial reporting may be accomplished by the following:

![Diagram showing fraudulent financial reporting: Manipulation/ Falsification (including Forgery)/ Alteration, Misrepresentation/ Intentional Omission, Intentional Misapplication of Accounting Principles]

Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

**Manipulation of Accounts:** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

(a) to avoid incidence of income-tax or other taxes;
(b) for declaring a dividend when there are insufficient profits;
(c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
(d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

(i) inflating or suppressing purchases and expenses;
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
IN THIS REGARD

(ii) inflating or suppressing sales and other items of income,
(iii) inflating or deflating the value of closing inventory;
(iv) failing to adjust outstanding liabilities or prepaid expenses; and
(v) charging items of capital expenditure to revenue or by capitalising revenue expenses.

Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

**Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.** Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.
Why do Management/ Employees commit fraud? What induces Management/ Employees to commit fraud? Following are certain instances which will help to understand these questions:

- Financial obligations/ Pressure.
- Management’s unrealistic goals.
- Dissatisfied Employees or Lack of motivation among employees.
- Name game (eg. management using power of authority by asking employees to do something illegal).
- Opportunity to commit fraud.

2.2.2 Misappropriation of Assets:

It involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
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♦ Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity’s purchasing agents in return for inflating prices, payments to fictitious employees).

♦ Using an entity’s assets for personal use (for example, using the entity’s assets as collateral for a personal loan or a loan to a related party).

Example

Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to ₹ 10,000. While performing the audit, Rajan, the auditor, noticed that there were many cheques of ₹ 9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than ₹ 10,000 each, into two or more cheques less than ₹ 10,000 each so that he may authorize the payments). This raised suspicion in the auditor.

The auditor found that the cheques of ₹ 9,999 were deposited in Vineet’s personal account i.e. Vineet had misappropriated the amount.

Splitting the cheques into lower amounts involves manipulation of accounts. The fraud was committed by an employee.

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.¹

2.2.2.1 Misappropriation of Goods

Fraud in the form of misappropriation of goods is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can

* Source of image: www.clipartster.com

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detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

Therefore, it is clear from the above that the ‘fraud’ deals with intentional misrepresentation but, ‘error’, on the other hand, refers to unintentional mistakes in financial information.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way.

2.2.2.2 Defalcation of Cash

Defalcation of cash has been found to perpetrate generally in the following ways:

(a) **By inflating cash payments:**

Examples of inflation of payments:

(1) Making payments against fictitious vouchers.
(2) Making payments against vouchers, the amounts whereof have been inflated.
(3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
(4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) **By suppressing cash receipts:**

Few techniques of how receipts are suppressed are:

(1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from
another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer’ accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

3. DETECTION OF FRAUD AND ERROR – DUTY OF AN AUDITOR

As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.
Broadly, the general principles laid down in the SA may be noted as under:

1. An auditor conducting an audit in accordance with SAs 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. As described in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing," owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

2. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

3. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

4. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
IN THIS REGARD

Case Study 1

While auditing XYZ Ltd., the auditor was told by Mr. Mahesh, the CEO of the company, that he would be responsible for the fraud & errors, if any, occurring in the books of accounts of the company.

Auditor’s Responsibilities for Detection of Fraud and Error: As per SA 240 “The Auditor’s Responsibilities relating to fraud in an audit of Financial Statements”, an auditor conducting an audit in accordance with SAs 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.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

An auditor conducting an audit in accordance with SAs 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.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

Case Study 2

After the completion of statutory audit of ABC Ltd., a fraud was detected at the office of the auditee. The management of the company alleged that there is a failure on the part of the auditor to detect fraud and that auditor would be responsible for not detecting fraud in the company.
### Detection of Fraud after Completion of Statutory Audit:

As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error.

An auditor conducting an audit in accordance with SAs 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. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor’s report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor’s report based on the results of these procedures.

The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.
4. FRAUD RISK FACTORS AND POSSIBILITY OF FRAUD

SA 240, further, explains by way of examples certain risk factors and circumstances relating to possibility of fraud as may be considered by the auditor which are dealt in the following paragraphs.

4.1 Fraud Risk Factors

Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Examples of Fraud Risk Factors: The fraud risk factors identified here are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor’s consideration, i.e.,

(A) fraudulent financial reporting, and
(B) misappropriation of assets.

For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur:

(a) incentives/pressures,
(b) opportunities, and
(c) attitudes/rationalizations.

Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all
of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

(A) Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting: The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting -

Incentives/Pressures: Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

1. High degree of competition or market saturation, accompanied by declining margins.
2. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
3. Significant declines in customer demand and increasing business failures in either the industry or overall economy.
4. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
5. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
6. New accounting, statutory, or regulatory requirements.

Opportunities: The nature of the industry or the entity’s operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

1. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
2. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm’s-length transactions.
3. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
4. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
5. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

**Attitudes/Rationalizations:** Communication, implementation, support, or enforcement of the entity’s values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.

1. Known history of violations of securities laws or other laws and regulations.
2. Excessive interest by management in maintaining or increasing the entity’s inventory price or earnings trend.
3. Management failing to remedy known significant deficiencies in internal control on a timely basis.
4. An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
5. The owner-manager makes no distinction between personal and business transactions.
6. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
   - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
   - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor’s report.
   - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
   - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

(B) **Risk Factors Arising from Misstatements Arising from Misappropriation of Assets:** Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur.
The following are examples of risk factors related to misstatements arising from misappropriation of assets:

**Incentives/Pressures:** Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

1. Known or anticipated future employee layoffs.
2. Recent or anticipated changes to employee compensation or benefit plans.
3. Promotions, compensation, or other rewards inconsistent with expectations.

**Opportunities:** Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

1. Large amounts of cash on hand or processed.
2. Inventory items that are small in size, of high value, or in high demand.
3. Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
4. Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. **For example, misappropriation of assets may occur because there is the following:**

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
IN THIS REGARD

♦ Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
♦ Lack of mandatory vacations for employees performing key control functions.
♦ Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
♦ Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations: Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

♦ Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
♦ Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
♦ Changes in behavior or life style that may indicate assets have been misappropriated
♦ Tolerance of petty theft.

4.2 Circumstances Relating to Possibility of Fraud

Examples of circumstances that indicate the possibility of fraud: The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud—
(A) Discrepancies in the accounting records, including:
- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees’ access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

(B) Conflicting or missing evidence, including:
- Missing documents.
- Documents that appear to have been altered.
- Significant unexplained items on reconciliations.
- Unusual discrepancies between the entity’s records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity’s record retention practices or policies.

Example

Raj is the auditor of XYZ Ltd. Raj is analysing the financial statements of the company by studying significant ratios. Some of the ratios that he studied was the gross profit ratio and net profit ratio. The gross profit ratio for the current year 2016-17 is 19% and for the previous year 2015-16 was 25%. Similarly, net profit ratio for the current year 2016-17 is 7%, whereas in previous year 2015-16 it was 11%.

There is a large variation in the gross profit ratio and net profit ratio over the two years. Hence, auditor has reason to believe that there may be something unusual. He will consider the results of such analytical procedures while drawing up his audit plan and allot more time to studying purchases.
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
IN THIS REGARD

Example

Analytical procedures exhibiting unusual ratios and trend e.g. unusually large transactions reported in the last month of the reporting period.

(C) Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

(D) Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity’s Code of Conduct.

5. FRAUD REPORTING

Reporting to the Central Government: As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been
committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

II. Reporting to the Audit Committee or Board: Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving
FRAUD AND RESPONSIBILITIES OF THE AUDITOR

IN THIS REGARD

lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub- rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

(a) Nature of Fraud with description;
(b) Approximate amount involved; and
(c) Parties involved.

III Disclosure in the Board’s Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board’s report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board’s Report the following details of each of the fraud reported to the Audit Committee or the Board under sub- rule (3) during the year:

(a) Nature of Fraud with description;
(b) Approximate Amount involved;
(c) Parties involved, if remedial action not taken; and
(d) Remedial actions taken.
Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that these provisions shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

**Reporting on Frauds already detected and reported:** The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's
vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.

However, in case of a fraud which involves or is expected to involve individually, an amount of ₹ 1 crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/ those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

**Reporting under Companies (Auditor’s Report) Order, 2016 [CARO, 2016]:** The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor’s Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor’s inquiry under this clause is restricted to frauds ‘noticed or reported’ during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor’s comments under this clause, the auditor is also required to comply with the requirements of SA 240, “The Auditor’s Responsibility Relating to Fraud in an Audit of Financial Statements”.
Audit Procedures and Reporting under CARO:

(1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

(2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(3) The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has

(a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

4. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written
representation from management that any uncorrected misstatements resulting from fraud are, in management’s opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, “We do not agree that items constitute misstatements because [description of reasons].”

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

5. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

   (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

   (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

   (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

6. AUDITOR UNABLE TO CONTINUE THE ENGAGEMENT

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor’s ability
to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal.

**SUMMARY**

SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” defines the term ‘fraud’ as “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage”.

Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Misappropriation of Assets involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts.
FRAUD AND RESPONSIBILITIES OF THE AUDITOR
IN THIS REGARD

As per SA 240 the primary responsibility for the prevention and detection of fraud rests with management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraud Reporting[Section 143(12) of Companies Act, 2013 & Rule 13 of CAAR, 2014]

A. Reporting of Fraud involving amount of less than 1 crore rupees: Auditor to Report Board/Audit Committee within 2 days of knowledge of fraud.

The auditor should Report the following matters:(a) Nature of Fraud with description;(b) Approximate amount involved; and (c) Parties involved.

Company is bound to disclose certain specified details in Board’s Report as (a) Nature of Fraud with description; (b) Approximate amount involved; (c) Parties involved, if remedial action not taken; and (d) Remedial actions taken.

B. Reporting of Fraud involving amount of rupees 1 crore or above: The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

♦ In case reply/observations received within stipulated time, the auditor is required
♦ to forward report along with reply/observations and comments to Central Government within 15 days of receipt of such reply/observations.
♦ In case reply/observations not received within stipulated time (within 45 days) the auditor should forward the report along with note containing details of report for which failed to receive any reply/observations to Central Government.

TEST YOUR KNOWLEDGE

MCQs

1. When credit purchases of ₹ 5,100 is recorded on credit side and credit sales of ₹ 5,100 is recorded on debit side, this kind of error is called__________.

(a) Error of omission
(b) Compensating error

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(c) Error of principle
(d) Error of commission

2. If as a result of a misstatement resulting from fraud, the auditor encounters exceptional circumstances that bring into question his ability to continue performing the audit, he shall-

(a) Withdraw from the engagement immediately
(b) Report to Audit team regarding withdrawal
(c) Determine the professional and legal responsibilities applicable in the circumstances.
(d) Ask the management for his withdrawal

3. Which of the following is an example of inflating cash payments?

(a) Making payments against purchase vouchers.
(b) Teeming and lading
(c) Not accounting for cash sales fully.
(d) Making payments against inflated vouchers.

4. The type of errors, existence of which becomes apparent in the process of compilation of accounts is known as:

(a) Self-revealing errors.
(b) Intentional errors
(c) Concealed errors
(d) Unconcealed errors.

5. Misappropriation of assets may occur because there is-

(a) Adequate record keeping with respect to assets
(b) Known history of violations of securities laws.
(c) Lack of complete and timely reconciliations of assets
(d) Dispute between shareholders in a closely held entity
Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

(I) Teeming and lading is one of the techniques of inflating cash payments.

(i) Fraud can be termed as intentional error

(iii) Auditor needs to report to Central Government in case of fraud involving 20 lakhs rupees.

(iv) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

(v) Fraudulent financial reporting only involves manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared.

Theoretical Questions

1. What do you understand by the term ‘fraud’? Provide its meaning as given as under the Standard on Auditing (SA) 240.

2. Briefly explain self-revealing errors with the help of some illustration.

3. There are many ways for cash defalcation, one of which is suppressing cash receipts. List out few techniques of how the receipts are suppressed.

4. Fraud Risk Factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Further, the nature of the industry or the entity’s operations also provides opportunities to engage in fraudulent financial reporting. List out some of the cases from where these opportunities may arise.

5. You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a statutory Auditor, how would you deal?

ANSWERS/SOLUTIONS

Answers to MCQs

1. (b) 2. (c) 3. (d) 4. (a) 5. (c)
Answers to Correct/Incorrect

(i) Incorrect: Teeming and Lading is one of the techniques of suppressing cash receipts and not of inflating cash payments. Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.

(ii) Correct: Fraud is the word used to mean intentional error. This is done deliberately which implies that there is intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.

(iii) Incorrect: As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

Thus fraud involving amount of 20 lakh rupees should be reported to Audit Committee.

(iv) Correct: As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”. It is important that management, with the oversight of those charged with governance place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detention and punishment. This involves a commitment to create a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.

(v) Incorrect: As per SA 240, “The Auditor’s Responsibilities Relating to fraud in an Audit of Financial Statements’, fraudulent financial reporting may involve manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared, misrepresentation in or intentional omission from, financial statements of events, transaction or other significant information or intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure.
Answer to Theoretical Questions

1. **Meaning of Fraud:** The SA 240 ‘The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements; defines the term fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

2. **Self Revealing Errors:** These are such errors the existence of which becomes apparent in the process of compilation of account. A few illustrations of such errors are given hereunder, showing how they become apparent.

<table>
<thead>
<tr>
<th>(i)</th>
<th>Omission to post a part of a journal entry to the ledger.</th>
<th>Trial balance is thrown out of agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii)</td>
<td>Wrong totaling of the Purchase Register</td>
<td>Control Account [e.g. the Sundry Trade payables Account] balances and the aggregate of the balance in the personal ledger will disagree.</td>
</tr>
<tr>
<td>(iii)</td>
<td>A failure to record in the cash book amounts paid into or withdrawn from the bank.</td>
<td>Bank reconciliation statement will show up error.</td>
</tr>
<tr>
<td>(iv)</td>
<td>A mistake in recording amount received from X in the account of Y.</td>
<td>Statements of account of parties will reveal mistake.</td>
</tr>
</tbody>
</table>

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

3. **Declaration of Cash by Supporting Cash Receipts:** Refer Para 2.2.2.2

4. **Fraud Risk Factors-Opportunities.** Refer 4.1

5. **Impossible to Continue the Performance of Audit:** refer Para 6.
AUDIT IN AN AUTOMATED ENVIRONMENT

After studying this chapter, you will be able to:

- Understand the meaning of an Automated environment.
- Understand the relevance of IT in an audit.
- Learn how to perform an understanding of an Automated environment and documenting the same.
- Identify the various risks in Automated environment and the corresponding controls.
- Gain knowledge of internal financial controls as per regulatory requirements.
- Recognize the way data analytics can be used in an audit.
- Learn to assess and report audit findings.
With the increasing adoption of information technology, business today rely on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company’s systems.

In this chapter, we will learn about the need, relevance and approach to be adopted when performing an audit in an Automated environment that is driven by IT systems and applications that are used in the preparation of financial statements of a company. We will see how the work performed with respect to Automated environment fits into the overall financial statement audit process. We will also understand how data analytics can become useful in an audit.

Finally, we will look at how to assess audit findings and report them to the stakeholders.

1. WHAT IS AN AUTOMATED ENVIRONMENT?

Let us first understand what the term “Automated Environment” means. An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

**Example**

Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using “apps” on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Some of the key features of an automated environment are as follows:

1.1 Key features of an Automated Environment

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business
environment is more automated, it is likely to be more complex.

<table>
<thead>
<tr>
<th>Enables faster business operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accuracy in data processing and computation</td>
</tr>
<tr>
<td>Ability to process large volumes of transactions</td>
</tr>
<tr>
<td>Integration between business operations</td>
</tr>
<tr>
<td>Better security and controls</td>
</tr>
<tr>
<td>Less prone to human errors</td>
</tr>
<tr>
<td>Provides latest information</td>
</tr>
<tr>
<td>Connectivity and Networking capability</td>
</tr>
</tbody>
</table>

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

**Example**

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

**2. RELEVANCE OF ‘IT’ IN AN AUDIT**

When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. Consider the following aspects instead of:

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).

Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more accurate, reliable, effective and efficient, such systems also introduce certain new risks, including IT specific risks, which need to be considered, assessed and addressed by management.

To the extent that it is relevant to an audit of financial statements, even auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.

[Note: Students may refer SA 315 – Identifying and assessing the risks of material misstatement through understanding the entity and its environment for detailed understanding]

In an audit of financial statements, the primary focus is around those risks that are relevant to financial reporting. However, there could be other non-audit assurance engagements that auditors maybe involved wherein the area of focus could include those IT risks relevant to company’s compliance and business operations in addition to financial reporting risks.

Examples of such non-audit assurance engagements are internal audits, IT audits, pre-implementation reviews, data migration audits, third party assurance.

With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsible for the implementation of internal controls framework within the company. The auditors’ responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls. We will learn more about IFC in
Given below are some situations in which IT will be relevant to an audit,

- Increased use of Systems and Application software in Business (for example, use of ERPs)
- Complexity of transactions has increased (multiple systems, network of systems)
- Hi-tech nature of business (Telecom, e-Commerce).
- Volume of transactions are high (Insurance, Banking, Railways ticketing).
- Company Policy (Compliance).
- Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE.
- Increases efficiency and effectiveness of audit.

In some of the above situations it is likely that carrying out audit using traditional substantive audit procedures may be difficult or even not feasible if the company prepares, records and conducts majority of business activities through IT systems only.

On the other hand, many companies may use less complex IT systems including desktop based accounting or spreadsheets. In such situations, the relevance of IT to an audit could be less. However, the auditor is still required to carry out at least an understanding the IT environment of the company and document the same.

Another area where IT can be relevant to audit is by using data analytics using computer assisted audit techniques (CAATs). By using data analytics, it is possible to improve the effectiveness and efficiency of an audit. We will learn more about data analytics in the later sections of this chapter.

From the above, we can see how IT is relevant to an audit under different situations viz., audit, non-audit and meeting regulatory compliance requirements. We will learn more about understanding risks, controls and documentation in further sections of this chapter.
3. RISKS & CONTROLS IN AN AUTOMATED ENVIRONMENT

3.1 Understanding and Documenting Automated Environment

In the previous section, we have learnt that, in an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company’s automated environment:

♦ Information systems being used (one or more application systems and what they are).
♦ Their purpose (financial and non-financial).
♦ Location of IT systems - local vs global.
♦ Architecture (desktop based, client-server, web application, cloud based).
♦ Version (functions and risks could vary in different versions of same application).
♦ Interfaces within systems (in case multiple systems exist).
♦ In-house vs Packaged.
♦ Outsourced activities (IT maintenance and support).
♦ Key persons (CIO, CISO, Administrators).

The understanding of a company’s IT environment that is obtained should be documented [Ref. SA 230 – Audit Documentation] using any standard format or template.

An example of one such template that can be used to document our understanding is illustrated below.

<table>
<thead>
<tr>
<th>Information Systems being used</th>
<th>Version</th>
<th>Purpose</th>
<th>Location - Local vs global</th>
<th>Architecture</th>
<th>Interfaces within systems</th>
<th>In-House vs. Packaged</th>
<th>Outsourced Activities</th>
<th>Key Persons</th>
<th>In-Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAP</td>
<td>ECC 6.0, EHPS</td>
<td>Accounting, Supply chain, Production</td>
<td>Texas, USA</td>
<td>Client/Server, Unix AIX 5.3, MS-SQL Server 2008</td>
<td>Paymaster</td>
<td>Packaging</td>
<td></td>
<td>CIO, Administrator</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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AUDIT IN AN AUTOMATED ENVIRONMENT

<table>
<thead>
<tr>
<th>PayMaster</th>
<th>5.3</th>
<th>Payroll</th>
<th>Gurgaon, India</th>
<th>Web-based, Windows, Apache, Oracle 11g</th>
<th>SAP, Accent</th>
<th>Package d</th>
<th>Payroll processed at ADP</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accent</td>
<td>2</td>
<td>Appraisal</td>
<td>Hyderabad, India</td>
<td>Lotus Notes, Windows</td>
<td>Paymaster</td>
<td>In-house</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Budget King</td>
<td>1</td>
<td>Management MIS Budgeting</td>
<td>Hyderabad, India</td>
<td>Web-based, Windows, Apache, Oracle 11 g</td>
<td>None</td>
<td>In-house</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

Having a summarized document helps the auditor in determining the areas considered in scope of audit as can be seen from the last column. In this illustration, it can be seen that two applications have been considered as in scope for audit based on the purpose and financial relevance to the audit.

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered:

- Inaccurate processing of data, processing inaccurate data, or both.
- Unauthorized access to data.
- Direct data changes (backend changes).
- Excessive access / Privileged access (super users).
- Lack of adequate segregation of duties.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Loss of data.

3.2 Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting

The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:
First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.

Second, we will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.

Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.

To mitigate the above (and more) risks and maintain the confidentiality, integrity,
availability and security of data, companies implement IT controls. Let us learn about the various types of IT controls in more detail.

### 3.3 Types of Controls in an Automated Environment

- General IT Controls
- Application Controls
- IT-Dependent Controls

#### 3.3.1 General IT Controls

“General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the **integrity** of information and **security of data** commonly include controls over the following:” (SA 315)

- Data center and network operations
- Program change
- Access security
- Application system acquisition, development, and maintenance (Business Applications)
These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls. Let us now learn about each of the General IT controls in more detail.

### Data Center and Network Operations

**Objective:** To ensure that production systems are processed to meet financial reporting objectives.

**Activities:**
- Overall Management of Computer Operations Activities
- Batch jobs – preparing, scheduling and executing
- Backups – monitoring, storage & retention
- Performance Monitoring – operating system, database and networks
- Recovery from Failures – BCP, DRP
- Help Desk Functions – recording, monitoring & tracking
- Service Level Agreements – monitoring & compliance
- Documentation – operations manuals, service reports

### Program Change

**Objective:** To ensure that modified systems continue to meet financial reporting objectives.

**Activities:**
- Change Management Process – definition, roles & responsibilities
- Change Requests – record, manage, track
- Making Changes – analyze, design, develop
- Test Changes – test plan, test cases, UAT
- Apply Changes in Production
- Emergency & Minor Changes
- Documentation – user/technical manuals
- User Training
Access Security

Objective: To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:
- Security Organization & Management
- Security Policies & Procedures
- Application Security
- Data Security
- Operating System Security
- Network Security – internal network, perimeter network
- Physical Security – access controls, environment controls
- System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

Application system acquisition, development, and maintenance

Objective: To ensure that systems are developed, configured and implemented to meet financial reporting objectives.

Activities:
- Overall Mgmt. of Development Activities
- Project Initiation
- Analysis & Design
- Construction
- Testing & Quality Assurance
- Data Conversion
- Go-Live Decision
- Documentation & Training

3.3.2 Application Controls

Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

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Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

### 3.3.3 IT dependent Controls

IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.

Due to the inherent dependency on IT, the effectiveness and reliability of Automated application controls and IT dependent controls require the General IT Controls to be effective.

### 3.3.4 General IT Controls vs. Application Controls

- These two categories of control over IT systems are interrelated.
- The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

### 4. TESTING METHODS

Having learnt about the various IT risks and controls, let us understand the different ways testing is performed in an automated environment. There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk.
AUDIT IN AN AUTOMATED ENVIRONMENT

assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

♦ Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
♦ Observe how a user processes transactions under different scenarios.
♦ Inspect the configuration defined in an application.

Example

Refer below screenshot of configuration for duplicate invoice check in SAP application.

- Inspect the system logs to determine any changes made since last audit testing.
Example

For example, refer below screenshot for the last modified date of depreciation calculation program in PeopleSoft application.

- Inspect technical manual / user manual of systems and applications.
- Carry out a test check (negative testing) and observe the error message displayed by the application.

Example

See below an error displayed by an application i.e. JD Edwards, when posting a transaction in closed period.

Conduct reperformance using raw source data and independently applying formulae, business rules or validations on the source data using CAATs.
Example

Refer below the screenshot of a query in MS Access for extraction of journal entries for above rupees 5 crores.

To rely on the system and application based information including data, reports, automated controls, configurations, calculations and IT dependent it is essential to first determine the existence and effectiveness of General IT Controls [ref para 3.3 above]. Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system based information [ref para 3.2 above].

5. INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:

♦ reliability of financial reporting
♦ effectiveness and efficiency of operations
♦ compliance with applicable laws and regulations
♦ safeguarding of assets
♦ prevention and detection of frauds

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. The table below gives a summary of the requirements of the Act.

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### Reference, Who is responsible, Applicability

<table>
<thead>
<tr>
<th>Reference</th>
<th>Who is responsible</th>
<th>Applicability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sec 134(5)(e)</td>
<td>Board of Directors</td>
<td>Listed Companies*</td>
</tr>
<tr>
<td>Rule 8 (5) of Companies (Accounts) Rules</td>
<td>Board of Directors</td>
<td>All Companies</td>
</tr>
<tr>
<td>Sec 149(8) and Schedule IV</td>
<td>Independent Directors</td>
<td>All companies having Independent Directors</td>
</tr>
<tr>
<td>Sec 177</td>
<td>Audit Committee</td>
<td>All companies having Audit committee</td>
</tr>
<tr>
<td>Sec 143(3) (i)</td>
<td>Statutory Auditors</td>
<td>All Companies#</td>
</tr>
</tbody>
</table>

* IFC is applicable from April 1, 2014 onwards, for companies.
# Auditor’s opinion on IFC is applicable from the financial year 2015-16 onwards wherein the Statutory Auditors, along with their opinion on financial statements, should also provide an Independent Opinion on the Design and Operating Effectiveness of Internal Financial Controls over Financial Reporting (IFC-FR) of the company as at Balance Sheet date.

The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls. The Guidance note on Audit of Internal Financial Controls over Financial Reporting issued by the Institute of Chartered Accountants of India provides a framework that auditors should follow to fulfil their responsibility. The below illustration is a summary of this controls based audit approach.

**Risk Assessment**
- Identify significant accounts and disclosures
- Qualitative and Quantitative considerations
- Relevant Financial Statement Assertions (FSA)
- Identify likely sources of misstatement
- Consider risk arising from use of IT systems

**Understand and Evaluate**
- Document understanding of business processes using Flowcharts/ Narratives
- Prepare Risk and Control Matrices (RCM)
- Understand design of controls by performing walkthroughs of end-to-end process
- Process wide considerations for Entity Level Controls, Segregation of Duties
- IT General Controls, Application Controls

**Test for Operating Effectiveness**
- Assess Nature, Timing and Extent (NTE) of controls testing
- Assess reliability of source data; completeness of population
- Testing of key reports and spreadsheets
- Sample testing
- Consider competence and independence of staff/team performing controls testing.

**Reporting**
- Evaluate Control Deficiencies
- Significant deficiencies, Material Weaknesses
- Remediation of control weaknesses
- Internal Controls Memo (ICM) or Management Letter
- Auditor’s report

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5.1 Audit Approach

6. DATA ANALYTICS FOR AUDIT

In today’s digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, “Data is the new Oil”.

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

♦ Check completeness of data and population that is used in either test of controls or substantive audit tests.
♦ Selection of audit samples – random sampling, systematic sampling.
♦ Re-computation of balances – reconstruction of trial balance from transaction data.
♦ Reperformance of mathematical calculations – depreciation, bank interest calculation.
♦ Analysis of journal entries as required by SA 240.
♦ Fraud investigation.
♦ Evaluating impact of control deficiencies.

There are several steps that should be followed to achieve success with CAATs and any of the supporting tools.
A suggested approach to benefit from the use of CAATs is given in the illustration below:

**7. ASSESS AND REPORT AUDIT FINDINGS**

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee [Students may refer SA 260 (Revised) – Communication with Those Charged with Governance for more details].

Some points to consider are as follows:

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal Controls Memo or Management Letter.
- Communicate in writing any significant deficiencies to Those Charged With Governance.
The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control. Refer to the flowchart to learn how this assessment should be carried out. This approach and thought process is the same when auditing in an automated environment or when auditing in a more manual environment.

A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing.

Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

The illustration below is an example of a control deficiency in General IT Controls and how this audit finding is reported to management.
7.1 Reporting Audit Findings – An Illustration

| **Password resets should be supported with proper request.** |
|---|---|
| **Observation** | As per Information Security Policy User Access changes should be initiated and approved. However, we observed that there is no formal process being followed for password reset in SAP. 
Password reset requests are presently communicated over phone and there is no supporting documentation being maintained for password reset requests. 
[Ref Information Security policy sub-section no........] |
| **Exposure** | Passwords of User ID with critical privileges may be reset and misused. 
Non-compliance with Information Security Policy. |
| **Recommendations** | It is recommended that all password resets should be requested through a formal process. 
Adequate supporting documentation should be maintained for user changes in SAP, including password resets, and reviewed periodically. |

**Management Response**

Comments

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**GLOSSARY**

| **Applications** | These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format. |
| **Audit evidence** | This is the data, information, reports that an auditor obtains during audit and forms the basis for an audit opinion. |
| **Automated** | A task or activity that is routinely performed by a computer system and does not require manual effort. |
| **CAATs** | Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence. |
### Audit in an Automated Environment

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Control Deficiency</strong></td>
<td>Exists when an internal control is either missing or not operating effectively to prevent or detect a misstatement in a timely manner by management.</td>
</tr>
<tr>
<td><strong>Data</strong></td>
<td>Refers to the digital content that is stored in electronic form within computer systems.</td>
</tr>
<tr>
<td><strong>Data Analytics</strong></td>
<td>A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information.</td>
</tr>
<tr>
<td><strong>Data Processing</strong></td>
<td>Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.</td>
</tr>
<tr>
<td><strong>Database</strong></td>
<td>A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.</td>
</tr>
<tr>
<td><strong>Direct Data Change</strong></td>
<td>A backend modification that is made directly to data that is stored in a database bypassing business rules built-in to a business application software.</td>
</tr>
<tr>
<td><strong>ERP Enterprise Resource Planning</strong></td>
<td>A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.</td>
</tr>
<tr>
<td><strong>Financial Reporting</strong></td>
<td>Refers to the process of preparation, presentation and disclosure of financial statements in accordance with a specified reporting framework.</td>
</tr>
<tr>
<td><strong>General (IT) Controls</strong></td>
<td>Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.</td>
</tr>
<tr>
<td><strong>Information</strong></td>
<td>Electronic data residing in computer systems that is organised in a logical and meaningful manner that is easy to read, understand and analyse.</td>
</tr>
<tr>
<td><strong>Information Systems</strong></td>
<td>Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.</td>
</tr>
</tbody>
</table>
| **Information Technology**  | The branch of science and engineering that involves designing, building, implementing and maintaining computer systems and networks that can be used in a
variety of ways including operating businesses and setting up information systems.

**Internal Controls**

Are the policies and procedures that a company implements to ensure efficiency of business operations, reliability of financial reporting, compliance with laws & regulations, safeguarding of assets and prevention of frauds.

**Mainframe**

A term that is used to describe a very large computer with high computing power, memory and storage that are required for running large business operations. In addition to business operations, Mainframes are also used in fields of Research & Development, Space, Healthcare, Weather, etc.

**Material Weakness**

A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management.

**Operating System**

Refers to a system software that is installed in a computer to convert high level user instructions or commands into low level machine understandable format and enable interaction with a computer.

**Privileged access**

A type of super user access to information systems that enforces less or no limits on using that system.

**Risk**

A possibility of something that can go wrong in a business process, transaction or operation and could result in a loss.

**Segregation of duties**

A type of internal control that is implemented in a company to prevent two or more conflicting functions from being assigned to or being carried out by the same person.

**Significant Deficiency**

A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a misstatement will not be prevented or detected in a timely manner by management.

**Software**

A computer program or a collection of computer programs
AUDIT IN AN AUTOMATED ENVIRONMENT

that provides an interface to a user for performing a specific activity, task, operation or transaction in electronic form through a computer or information system.

System

Reffer to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.

ABBREVIATION

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>IS</td>
<td>Information System</td>
</tr>
<tr>
<td>ATM</td>
<td>Automated Teller Machine</td>
</tr>
<tr>
<td>SA</td>
<td>Standards on Auditing</td>
</tr>
<tr>
<td>CIO</td>
<td>Chief Information Officer</td>
</tr>
<tr>
<td>CISO</td>
<td>Chief Information Security Officer</td>
</tr>
<tr>
<td>ELC</td>
<td>Entity Level Controls</td>
</tr>
<tr>
<td>FSLI</td>
<td>Financial Statement Line Item</td>
</tr>
<tr>
<td>GITC</td>
<td>General Information Technology Controls</td>
</tr>
<tr>
<td>IPE</td>
<td>Information Produced by Entity</td>
</tr>
<tr>
<td>FSA</td>
<td>Financial Statement Assertion</td>
</tr>
<tr>
<td>RCM</td>
<td>Risk &amp; Control Matrix</td>
</tr>
<tr>
<td>NTE</td>
<td>Nature, Timing &amp; Extent</td>
</tr>
<tr>
<td>ICM</td>
<td>Internal Controls Memorandum</td>
</tr>
<tr>
<td>SOD</td>
<td>Segregation of Duties</td>
</tr>
<tr>
<td>ERM</td>
<td>Enterprise Risk Management</td>
</tr>
<tr>
<td>COSO</td>
<td>Committee of Sponsoring Organisations</td>
</tr>
<tr>
<td>CAATS</td>
<td>Computer Assisted Auditing Techniques</td>
</tr>
<tr>
<td>ACL</td>
<td>Audit Command Language (CAAT Tool)</td>
</tr>
<tr>
<td>ISO</td>
<td>International Organization for Standardization</td>
</tr>
<tr>
<td>IFC</td>
<td>Internal Financial Controls</td>
</tr>
</tbody>
</table>
An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems.

The fundamental principle of an automated environment is the ability carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation. As the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly.

The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately. To mitigate the above (and more) risks and maintain the confidentiality, integrity, availability and security of data, companies implement IT controls.

Three types of controls in automated environment are (i) General IT Controls (ii)
Application Controls and (iii) IT-Dependent Controls.

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools.

A deficiency in internal control exits if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures.

**TEST YOUR KNOWLEDGE**

**MCQs**

1. Which of the following is a General IT control?
   - (a) IT Environment
   - (b) Application Control
   - (c) Access Security
   - (d) IT Dependent Control

2. Which of the following is an automated control?
   - (a) Program change
   - (b) System generated report
   - (c) Application control
   - (d) Configurations

3. Who is mainly responsible for implementation of internal financial controls in a company?
   - (a) Auditors
   - (b) Directors
   - (c) Employees
   - (d) Regulators
4. The Guidance Note on Audit of Internal Financial Controls over Financial Reporting has been issued by?
   (a) ICAI
   (b) SEBI
   (c) MCA
   (d) RBI

5. The standard that requires auditors to analyse journal entries in an audit is?
   (a) SA 260
   (b) SA 230
   (c) SA 315
   (d) SA 240

**Correct/Incorrect**

State with reasons (in short) whether the following statement is correct or incorrect:

(i) All automated environments are complex.

(ii) In an audit of financial statements, the auditor should plan response to all IT risks.

(iii) General IT controls support the functioning of Application controls.

(iv) Inquiry is often the most efficient audit testing method, but least effective.

(v) Specialised audit tools like IDEA, ACL are required to perform data analytics.

**Theoretical Questions**

1. Briefly mention three reasons why IT should be considered relevant to an audit of financial statements.

2. Describe how risks in IT systems, if not mitigated, could have an impact on audit

3. What are the different testing methods used when auditing in an automated environment. Which is the most effective and efficient method of testing?
ANSWERS/SOLUTIONS

Answers to MCQs
1. (c) 2. (d) 3. (b) 4. (a) 5. (d)

Answers to Correct/Incorrect
(i) Incorrect: The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.

(ii) Incorrect. The auditor should plan response to those IT risks that are relevant to financial reporting and not “all” IT risks.

(iii) Correct. General IT controls support the functioning of automated application controls and IT dependent controls.

(iv) Correct. Inquiry is the most efficient but least effective. Moreover, testing through inquiry alone is not sufficient. Inquiry should be corroborated by applying any one or a combination of observation, inspection or reperformance.

(v) Incorrect. Even though specialised audit tools are very useful, such tools are not always required or necessary to carry out data analytics. More commonly available spreadsheet applications like MS-Excel can also be effectively used for carrying out data analytics.

Answers to Theoretical Questions
1. The auditor should consider relevance of IT in an audit of financial statements for the following reasons:

   (a) Since auditors rely on the reports and information generated by IT systems, there could be risk in the IT systems that could have an impact on audit.

   (b) Standards on auditing SA 315 and SA 330 require auditors to understand, assess and respond to risks that arise from the use of IT systems.

   (c) By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.
2. When risks in IT systems are not mitigated the audit impact could be as follows:

(i) The auditor may not be able rely on the reports, data obtained, automated controls, calculations and accounting procedures in the IT system.

(ii) The auditor has to perform additional audit work by spending more time and efforts.

(iii) The auditor may have to issue a modified opinion, if necessary.

3. When auditing in an automated environment, the following testing methods are used:

(a) Inquiry
(b) Observation
(c) Inspection
(d) Reperformance

A combination of inquiry and inspection is generally the most effective and efficient testing method. However, determining the most effective and efficient testing method is a matter of professional judgement and depends on the several factors including risk assessment, control environment, desired level of evidence required, history of errors /misstatements, complexity of business, assertions being addressed.
AUDIT SAMPLING

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Define Audit Sampling as per Standards on Auditing 530 and its importance.
- Identify the Approaches to Audit Sampling and Sample Selection Methods.
- Gain knowledge of sample design, size, and selection of items for testing and Sampling Risk.
- Understand the sampling techniques and how/when to apply them to audit procedures.

CHAPTER OVERVIEW

Audit Sampling (SA 530)

- Meaning of audit sampling
- Approaches to audit sampling
- Sample design, size, and selection of items for testing
- Performing audit procedures
- Nature and cause of deviations and misstatements
- Projecting mis-statements
- Evaluating results of audit sampling

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1. SAMPLING: AN AUDIT PROCEDURE

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

2. MEANING OF AUDIT SAMPLING

According to SA 530 “Audit sampling”, ‘audit sampling’ refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on
which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

### 2.1 Population

Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

#### 2.1.1 Characteristics of Population

1. **Appropriateness**: The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective.

   **Example**

   If the auditor’s objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers’ statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

   The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways.

   **Example**

   If the auditor’s objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

   It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

2. **Completeness**: The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the
population needs to include all relevant items from throughout the entire period.

3. **Reliable**: When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate.

### 3. APPROACHES TO SAMPLING

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

**Statistical sampling** is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered **non-statistical sampling**.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor’s judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

**Sample must be representative**

**Whatever may be the approach non-statistical or statistical sampling, the sample must be representative.** This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
3.1 Statistical Sampling- More Scientific

Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

3.2 Non-Statistical Sampling

Under this approach, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June and September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

(i) Size of the organisation under audit.
(ii) State of the internal control.
(iii) Adequacy and reliability of books and records.
(iv) Tolerable error range.
(v) Degree of the desired confidence.

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client’s organisation because they provide the reliability of the records. What should be the extent of desirable checking in any particular matter is for auditor to judge on basis of his opinion about the state of control in a particular area. If control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains. On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual’s judgment in that particular case.

**Example**

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice – if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.
Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

### 3.3 Appropriateness of Sampling Approaches

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor’s opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective.

**The advantages of statistical sampling may be summarized as follows** -

1. The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
2. The sample selection is more objective and thereby more defensible.
3. The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
4. It provides a means for deriving a “calculated risk” and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
5. It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort, for instance when exact accuracy is required or in case of legal requirements etc.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor’s judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

### 4. SAMPLE DESIGN, SIZE AND SELECTION OF ITEMS FOR TESTING

When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce
sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

4.1 Sample Design

When designing an audit sample, the auditor’s consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of SA 500 Audit Evidence, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor’s consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

Example

In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor’s understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

Example

If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.
Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

**4.1.1 Stratification and Value-Weighted Selection**

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

**Stratification:** Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

**Example**

20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the
misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

**Value-Weighted Selection:** When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

### 4.2 Sample Size

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. There are various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

#### 4.2.1 Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor’s risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor’s assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor’s assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests
of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor’s tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

♦ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.

♦ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor’s consideration of the expected rate of deviation include the auditor’s understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

♦ An increase in the auditor’s desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

♦ In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

4.2.2 Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.
The higher the auditor’s assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor’s assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor’s risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be. Thus we can say that there will be an increase in sample size in case of an increase in the auditor’s assessment of the risk of material misstatement.

The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be. Hence, if there is an increase in the use of other substantive procedures directed at the same assertion, the size of sample will decrease.

An increase in the auditor’s desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

An increase in tolerable misstatement will decrease the sample size as lower the tolerable misstatement, the larger the sample size needs to be.

The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor’s consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. So sample size will increase in case of an increase in the amount of misstatement the auditor expects to find in the population.

When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of
items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

♦ There will be negligible effect on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures.)

Data Analytics - Data analytics is defined as the process of inspecting, cleaning, transforming and modelling data with the goal of highlighting useful Information, suggesting conclusions and supporting decision making.

For example, JE Testing is a Data Analytic Tool.

4.3 Selection of Items for Testing

With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

4.4 Sample Selection Methods

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.
Some of the important methods of selecting the sample are discussed below -

(1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–

(i) **Simple Random Sampling:** Under this method each unit of the whole population *e.g.* purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.
Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.

(ii) **Stratified Sampling**: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

Example

In the above case, trade receivables balances may be divided into four groups as follows:-

(a) balances in excess of ₹ 10,00,000;
(b) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
(c) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;
(d) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and
(e) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Therefore, we can say that random selection method is applied through random number generators, for example, random number tables).

(2) **Interval Sampling or Systematic Sampling**: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is
selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Example

If in a population of branch sales, particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(5) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.
There is a close similarity between this method and non-statistical sampling. Consequently it has similar characteristics, namely, simplicity and economy. On the other hand there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

### 4.5 Sampling and Non-Sampling Risk

**Sampling Risk.** The risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

**Non-Sampling Risk.** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

**Example**

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of Non Sampling risk are:

<table>
<thead>
<tr>
<th>Human Mistakes</th>
<th>Misinterpreting the sample results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applying audit procedures not appropriate to the objectives of audit</td>
<td></td>
</tr>
<tr>
<td>Relying on erroneous information e.g. erroneous confirmation</td>
<td></td>
</tr>
</tbody>
</table>

Non sampling risk can never be mathematically measured.
5. PERFORMING AUDIT PROCEDURES

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined.

An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

6. NATURE AND CAUSE OF DEVIATIONS AND MISSTATEMENTS

In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

* Source for image Jasonbloomaccounting.com

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Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

7. PROJECTING MISSTATEMENTS

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

8. EVALUATING RESULTS OF AUDIT SAMPLING

The auditor shall evaluate-

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor’s best estimate of misstatement in the
population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor’s expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

**SUMMARY**

SA 530 “Audit Sampling”, defines ‘audit sampling’ as application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Audit sampling can be applied using either non-statistical or statistical sampling approaches.

The factors that should be considered for deciding upon the extent of checking on a sampling plan are size of the organisation under audit, state of the internal control, adequacy and reliability of books and records, tolerable error range and degree of the desired confidence.

Sample should be selected in such a manner that it is representative of the
population from which the sample is being selected. Some of the sample selection methods are Random Sampling (Simple/Stratified), Systematic Sampling, Monetary Unit Sampling, Haphazard Sampling, Block Sampling etc.

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. The auditor is also required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

The auditor shall evaluate the results of the sample; and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

TEST YOUR KNOWLEDGE

MCQs

1. The main advantage of using statistical sampling techniques is that such techniques:
   (a) Mathematically measure risk
   (b) Eliminate the need for judgmental sampling
   (c) Defines the values of tolerable error
   (d) All of the them.

2. Which of the following factors is (are) considered in determining the sample size for tests of control?
   (a) Projected error
   (b) tolerable error
   (c) Expected error
   (d) Both (b) and (c)

3. Tolerable error is the maximum monetary error that the auditor is prepared to accept in the population and still conclude that audit objective has been achieved, is directly related to
   (a) Sample size
   (b) Audit risk
   (c) Materiality
4. Which of the following is source of Non Sampling risk:
   (a) Human Mistakes
   (b) Applying audit procedures not appropriate to the objectives of audit
   (c) Misinterpreting the sample results
   (d) All of the above

5. Which of the following is more scientific:
   (a) Statistical
   (b) Non-statistical
   (c) both (a) and (b)
   (d) none of the above

**Correct/Incorrect**

State with reasons (in short) whether the following statement is correct or incorrect:

(i) The method which involves dividing the population into groups of items is known as block sampling.

(ii) Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

(iii) Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

(iv) Sample need not be representative

(v) The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

**Theoretical Questions**

1. What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 “Audit Sampling”.

2. With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.
3. While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

4. Write short notes on the following:
   (a) Advantages of Statistical sampling in Auditing.
   (b) Stratified sampling

**ANSWERS/SOLUTIONS**

**Answers to MCQs**

1. (a) 2. (d) 3. (c) 4. (d) 5. (a)

**Answers to Correct/Incorrect**

(i) **Incorrect**: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

(ii) **Incorrect**: Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

(iii) **Incorrect**: Statistical sampling is an approach to sampling that has the random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

(iv) **Incorrect**: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

(v) **Incorrect**: The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

**Answers to Theoretical Questions**

1. **Meaning of Audit Sampling**: “Audit Sampling” means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Refer Para 4.4 for methods of selecting samples.
2. **Audit Sampling:** As per SA 530 on “Audit Sampling”, the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

**Sample design** - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

**Sample Size** - The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

**Selection of Items for Testing** - The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

3. **Risk Factors while applying Sampling Techniques:** As per SA 530 “Audit Sampling”, sampling risk is the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

   (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

   (ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

4. (a) **Advantages of Statistical Sampling in Auditing:** Refer Para 3.3.

   (b) **Stratified Sampling:** Refer Para 4.4.
After studying this chapter, you will be able to:

- Understand the meaning of analytical procedures as per Standards on Auditing.
- State the purposes and timing of analytical procedures.
- Deal with the auditor’s use of analytical procedures as substantive procedures ("substantive analytical procedures").
- Identifying risk of material misstatement through preliminary Analytical review procedures.
- Properly designing, documenting and evaluating the results of substantive analytic review procedures.

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1. MEANING OF ANALYTICAL PROCEDURES

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 “Analytical Procedures”, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Thus, analytical procedures include the consideration of comparisons of the entity’s financial information with as well as consideration of relationships.

Examples of Analytical Procedures having consideration of comparisons of the entity’s financial information with are:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
Examples of Analytical Procedures having consideration of relationships are:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

**ILLUSTRATION**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Client</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2015-16</td>
<td>2015-16</td>
</tr>
<tr>
<td></td>
<td>2016-17</td>
<td>2016-17</td>
</tr>
<tr>
<td>Inventory Turnover</td>
<td>2.8</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>2.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>22.5%</td>
<td>23.6%</td>
</tr>
<tr>
<td></td>
<td>22.7%</td>
<td>22.2%</td>
</tr>
</tbody>
</table>

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Thus, we can say that Analytical Procedures may be segregated into these major types as comparison of client and industry data, comparison of client data with similar prior period data, comparison of client data with client-determined expected results, comparison of client data with auditor-determined expected results and comparison of client data with expected results, using non financial data.

### 2. PURPOSE AND TIMING OF ANALYTICAL PROCEDURES

#### 2.1 Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

**Analytical procedures are used for the following purposes:**

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the
financial statements are consistent with the auditor’s understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year, reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

**Example**

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

On verifying the balances of **sundry account receivables** by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

Also whether in the case of **account payable**, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

In case of **inventories of raw materials and stores** at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

By reconciling the **amounts of interest and dividends** collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making **inter-firm and intra-firm comparison** of trading results.
ANALYTICAL PROCEDURES

Example

If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period. It would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance, the cost of importing goods which are subject to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by a sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that...
might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

### 2.2 Timing of Analytical Procedures

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

![Diagram of Audit Phases]

#### 2.3 Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client’s business and in identifying areas of potential risk by indicating aspects of and developments in the entity’s business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

### 3. SUBSTANTIVE ANALYTICAL PROCEDURES

The auditor’s substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor’s judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of
any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

### 3.1 Factors to be considered for Substantive Audit Procedures

The auditor should consider the following factors for Substantive Audit Procedures:

**Availability of Data** – The availability of reliable and relevant data will facilitate effective procedures.

**Disaggregation** – The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

**Account Type** – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

**Example**

We can analyze data to understand the relationship to another account and through this, disaggregate the transactions flowing to and from the balance sheet account (e.g., sales and cash receipts flowing through trade receivables), or to compare ratios over time as this enhances our ability to obtain audit evidence for balance sheet accounts.

**Source** – Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs are often subject to management judgment and therefore more difficult to predict.

**Predictability** – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

**Nature of Assertion** – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.
Inherent Risk or “What Can Go Wrong” – When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Example

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

3.2 Techniques Available as Substantive Analytical Procedures

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

Trend analysis – A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Example

Financial ratios may include:

- Trade receivables or inventory turnover
- Freight expense as a percentage of sales revenue

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more
applicable to income statement accounts and certain accrual or prepayment accounts.

**Structural modelling** – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

### 3.3 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(ii) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

### 4. SUITABILITY OF PARTICULAR ANALYTICAL PROCEDURES FOR GIVEN ASSERTIONS

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor’s assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an
analytical procedure.

**Example**

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor’s assessment of the risk of material misstatement. **For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.**

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. **For example, when obtaining audit evidence regarding the valuation assertion for accounts**
receivable balances, the auditor may apply analytical procedures to an aging of customers’ accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

5. EXTENT OF RELIANCE ON ANALYTICAL PROCEDURES

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity’s preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.
6. RISK OF MATERIAL MISSTATEMENTS

Matters relevant to the auditor’s evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

7. INVESTIGATING RESULTS OF ANALYTICAL PROCEDURES

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses: Audit evidence relevant to management’s responses may be obtained by evaluating those responses taking into account the auditor’s understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
(ii) **Performing other audit procedures as necessary in the circumstances:**
The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management’s response, is not considered adequate.

8. **ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION**

The conclusions drawn from the results of analytical procedures designed and performed in accordance with, are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor’s opinion. Students may note that Analytical Procedures assisting for forming an overall conclusion will be discussed in details at Final level.

9. **CONSIDERATIONS SPECIFIC TO PUBLIC SECTOR ENTITIES**

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

**SUMMARY**

As per “SA 520 Analytical Procedures”, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical Procedures are required in the planning phase, testing phase and during the completion phase.
These Analytical procedures are used to obtain relevant and reliable audit evidence when using substantive analytical procedures; and to design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

The auditor’s substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both.

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

Matters relevant to the auditor’s evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by inquiring with management or by performing audit procedures.

The conclusions drawn from the results of analytical procedures designed and performed are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor’s opinion.

**TEST YOUR KNOWLEDGE**

**MCQs**

(i) What are analytical procedures?

(a) Substantive tests designed to assess control risk

(b) Substantive tests designed to evaluate the validity of management’s representation letter

(c) Substantive tests designed to study relationships between financial and non-financial data

(d) All of the above

2. Which of the following is not an analytical procedure?

(a) Tracing of purchases recurred in the purchase book to purchase invoices.
(b) Comparing aggregate wages paid to number of employees
(c) Comparing the actual costs with standard costs
(d) All of them are analytical procedures

3. Analytical procedures issued in the planning stage of an audit, generally:
(a) help to determine the nature, timing and extent of other audit procedures
(b) direct attention to potential risk areas
(c) indicate important aspects of business
(d) All of the above

4. The basic assumption underlying the use of analytical procedures is:
(a) It helps the auditor to study relationship among elements of financial information
(b) Relationship among data exist and continue in the absence of known condition to the contrary
(c) Analytical procedures will not be able to detect unusual relationships
(d) None of the above

5. What is the primary objective of analytical procedures used in the overall review stage of an audit?
(a) To help to corroborate the conclusions drawn from individual components of financial statements
(b) To reduce specific detection risk
(c) To direct attention to potential risk areas
(d) To satisfy doubts when questions arise about a client’s ability to continue

Correct/Incorrect
State with reasons (in short) whether the following statement is correct or incorrect:

1. As per the Standard on Auditing (SA) 520 “Analytical Procedures” ‘the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among financial data only.'
2. Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.

3. Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

4. Analytical Procedures are required in the planning phase only.

5. Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

**Theoretical Questions**

1. Define Analytical Procedures.

2. What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on “Analytical procedures”.

**ANSWERS/SOLUTIONS**

**Answers to MCQs**

1. (c)  
2. (a)  
3. (d)  
4. (b)  
5. (a)

**Answers to Correct/Incorrect**

1. Incorrect. As per the Standard on Auditing (SA) 520 “Analytical Procedures” the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

2. Incorrect. Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

3. Incorrect. Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

   (i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

   (ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether
4. **Incorrect.** Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

5. **Incorrect.** Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

**Answers to Theoretical Questions**

1. **Meaning of Analytical Procedures:** As per the Standard on Auditing (SA) 520 “Analytical Procedures,” the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. Thus, analytical procedures include the consideration of comparisons of the entity’s financial information with as well as consideration of relationships.

2. **Extent of Reliance on Analytical Procedures (SA-520):** Refer Para 5