## Basics Concepts

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<th>Audit Process</th>
<th>Description</th>
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<td>(a)</td>
<td>Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.</td>
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<td>(b)</td>
<td>Examination and evaluation of the nature, extent and efficacy of the system of internal control.</td>
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<td>(c)</td>
<td>Ascertaining the arithmetical accuracy of the books of accounts.</td>
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<td>(d)</td>
<td>Examining the documentary evidence and the authority in support of the transaction.</td>
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<td>(e)</td>
<td>Checking the validity of transactions with reference to:</td>
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<td>(i) provisions affecting the accounts and audit in any Act or Rules;</td>
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<td>(ii) rules and regulations governing the constitution and management of the organisation;</td>
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<td>(iii) minute books for appropriate sanction;</td>
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<td>(iv) other legal documents; and</td>
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<td>(v) well recognised accounting principles and practices.</td>
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<td>(f)</td>
<td>Ensuring that there is adequate disclosure of information.</td>
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<td>(g)</td>
<td>Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.</td>
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<tr>
<td>(h)</td>
<td>Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.</td>
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<tr>
<td>(i)</td>
<td>Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.</td>
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### 3.2 Auditing and Assurance

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<th>(j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.</th>
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<td>▶ The client’s annual reports to shareholders.</td>
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<td>▶ Minutes of meetings of shareholders, board of directors and important committees.</td>
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<td>▶ Internal financial management reports for current and previous periods, including budgets, if any.</td>
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<td>▶ The previous year’s audit working papers and other relevant files.</td>
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<td>▶ Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.</td>
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<td>▶ Discussions with client.</td>
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Preparation for an Audit  3.3

- The client’s policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- Consideration of the state of the economy and its effect on the client’s business.
- Visits to the client’s premises and plant facilities.

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 judgments regarding the appropriateness of accounting policies and disclosures.

<table>
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<tr>
<th>Development of an Overall Plan</th>
<th>The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:</th>
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<td>- The terms of his engagement and any statutory responsibilities.</td>
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<td>- The nature and timing of reports or other communication.</td>
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<td>- The applicable legal or statutory requirements.</td>
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<td>- The accounting policies adopted by the client and changes in those policies.</td>
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<td>- The effect of new accounting or auditing pronouncements on the audit.</td>
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<td>- The identification of significant audit areas.</td>
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<td>- The setting of materiality levels for audit purposes.</td>
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<td>- Conditions requiring special attention.</td>
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<td>- The degree of reliance he expects to be able to place on accounting system and internal control.</td>
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<td>- Possible rotation of emphasis on specific audit areas.</td>
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<td>- The nature and extent of audit evidence to be obtained.</td>
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<td></td>
<td>- The work of internal auditors and the extent of their involvement, if any, in the audit.</td>
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</table>
### Audit and Assurance

- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

| Audit Programme | 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. For the purpose of programme construction, the following points should be kept in view:
|               | 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. |

| 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. There are many methods of selecting samples. The principal methods are as follows:
|                           | (a) Random selection (applied through random number generators, for example, random number tables).
|                           | (b) Systematic selection, 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 |
Question 1

“In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed”. Comment.

Answer

Selection of Audit Sample: Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.
Question 2

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 “Audit Sampling”.

Answer

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.

There are many methods of selecting samples. The principal methods are as follows:

(a) Random Selection: This method is applied through random number generators, for example, random number tables. Stratified Sampling is one of the methods of Random Sampling. This method involves dividing the whole population to be tested in a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement e.g. entire expense vouchers may be divided into:

(i) Vouchers above ₹ 1,00,000
(ii) Vouchers between ₹ 25,000 and ₹ 1,00,000
(iii) Vouchers below ₹ 25,000

The auditor can then decide to check all vouchers above ₹ 1,00,000, 50% between ₹ 25,000 and ₹ 1,00,000 and 25% of those below ₹ 25,000.

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.

(b) Systematic Selection: In this method, 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 computerised 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.

(c) Monetary Unit Sampling: This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
(d) **Haphazard Selection:** In this method, 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.

(e) **Block Selection:** 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.

**Question 3**

*Write short notes on the following:*

(a) **Audit Note-book**

(b) **Continuous Audit – Advantages and disadvantages.**

**Answer**

(a) **Audit Note Book:** An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. Audit note books form part of audit working papers and for each year a fresh audit note book is maintained. In case an auditor classifies his working paper into permanent and current, then audit note book shall form part of the current file. It is in any case a part of the permanent record of the auditor available for reference later on, if required.

The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily. It is also used for recording the various queries raised in the course of the work and their state of disposal. In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book, while queries remaining undisposed of would be noted for follow up.

(b) **Continuous Audit:** A continuous audit is one in which the auditor’s staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period.
3.8 Auditing and Assurance

A continuous audit is preferred for the following reasons:

(i) It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors or frauds uncovered by such an audit.

(ii) The frequent attendance by the staff deters persons so inclined from committing a fraud.

(iii) The accounting staff of the client is motivated to keep the books of account up-to-date.

(iv) The constant association of the auditor with the accounts and the affairs of the client provides him with an opportunity to obtain a more detailed knowledge of the client’s affairs, one of the effects thereof is that he is able to discharge his duties more efficiently.

There are certain drawbacks also, in the continuous audit, as under:

(i) Due to the audit being carried out in several installments, the audit staff may fail to keep track of things which they had not checked on their last or an earlier visit as a result whereof some of the transactions may escape audit scrutiny. The safeguard against such a position can be that on each visit, elaborate notes and check-lists should be prepared and audit should be completed up to a definite stage each time so as not to leave any loose ends.

(ii) The books of account, after these have been checked, may be tampered by the client’s staff. This is a more serious matter requiring appropriate safeguards and action on the part of the management.

(iii) The audit may be uneconomic if the size of the concern is small since a great deal of time and effort would be wasted each time in preparing for the audit and in attending to the requirements of the audit party.

Question 4

State the purpose of a ‘Letter of Engagement’.

Answer

Letter of Engagement: The legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases, the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract.

The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards.

Clients who are not statutorily required to get their accounts audited may require preparation of
accounts for tax returns, checking of the sales tax -returns, etc. besides audit. In such cases, there may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts, is also covered. It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement. It must be reduced in writing and should exactly specify the scope of the work.

The audit engagement letter is sent by the auditor to his client which documents, the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued Standard on Auditing 210 “Agreeing the Terms of Audit Engagement” 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.

SA 210 lays down the standards on agreeing the terms of the engagement with the client and the auditor’s response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

Question 5

In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”.

Answer

Obtaining Knowledge of the Business: The auditor needs to obtain a level of knowledge of the client’s business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

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
(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.
3.10 Auditing and Assurance

(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.

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 judgement regarding the appropriateness of accounting policies and disclosures.

Question 6

Medical Council of India organised a three-day International Conference of Doctors in Delhi. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference. Mention any six points, peculiar to the situation, which you will like to include in your audit programme.

Answer

Audit of Receipts of Participation Fees: The organization of three-day International Conference of Doctors in Delhi by Medical Council of India is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas-

(I) Internal Control System

(i) Examine the organization structure of special cell created for the International Conference, if any, and division of responsibilities amongst persons and control/custody over receipt books.

(ii) Verify the internal control system for restricting the participation of unregistered delegates.

(II) Rate of Participation Fees

(i) Verify with reference to resolution passed by the Organizing Committee/Medical Council of India.

(ii) Also verify the rate from the literature/registration form circulated for promotion of conference.

(III) Receipts of Participation Fees

(i) Verify counter foil of the receipts issued for individual registration.
(ii) Ensure that receipts are issued for all the registration received in cash.

(iii) Trace the receipts in Bank Statement or Cash Book – as the case may be.

(iv) Verify Bank Reconciliation Statement and list out dishonoured cheques.

(v) Verify subsequent recovery in respect of dishonoured cheques.

(IV) Overall Checking

(i) Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.

(ii) Cross check the total number of delegates with reference to the following:
   (a) Kits distributed to participants.
   (b) Bill of caterer for providing meals during conference.
   (c) Capacity of the Hall.
   (d) Participation Certificate if any issued.

(V) Foreign Delegates: In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

(VI) Special Issues

(i) Take out list of absentees and in case of nil absentees, probe the issue further.

(ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

Question 7

Explain the Inherent Risk with reference to the relevant Standards on Auditing.

Answer

Inherent Risk: 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.

As per SA 330 "The Auditor's Responses to Assessed Risks", while designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk) and obtain more persuasive audit evidence the higher the auditor's assessment of risk.

As per SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", for this purpose, the auditor shall:
(i) 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;

(ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(iii) 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

(iv) 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.

Question 8

Briefly explain Management Representation.

Answer

Management Representation: SA 580 “Written Representations” deals with the auditor’s responsibility to obtain written representations from management and, where appropriate, those charged with governance. 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. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

Question 9

Write a short note on - Audit Programme.

Answer

Audit Programme: An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. 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. For the purpose of framing an audit programme the following points should be kept in view:

- Audit objective
- Audit procedure to be applied
- Extent of check
- Timing of check
- Allocation of work amongst the team members
- Special instructions based on past experience of the auditee.

### Question 10

**Answer the following:**

(a) How does an audit programme help to plan and perform the audit?

(b) Draft an audit programme to audit the receipts of a cinema theatre owned by a partnership firm.

**Answer**

(a) **The Role of Audit Programme in Audit Plan and Performance:** The audit programme is helpful both in planning and performance stages of audit-

(i) The audit programme lists down areas of audit before commencement.

(ii) The audit timing is built therein; thereby it becomes a schedule of audit plan.

(iii) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.

(iv) It specifies the procedures to be checked during the audit.

(v) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.

(vi) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.

(vii) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.

(viii) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.

(b) **Programme for Receipts of Cinema Theatre of a Firm:** Audit programme for checking the receipts of a cinema theatre of a partnership firm-

(i) The partnership deed should be first scrutinized.
(ii) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.

(iii) The internal control for collections from sale of tickets should be checked.

(iv) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.

(v) Check the rough cash book and reconcile from the inventory of ticket books issued, the cash to be collected each day.

(vi) Check that the cash balance and ticket sales from inventory is daily checked by the manager.

(vii) Check that the collections are banked daily, the very next day.

(viii) See rates for each class and the ticket rates are as per current prices.

(ix) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.

(x) Check the relation between the amounts of tax collected and sales.

(xi) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.

(xii) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.

(xiii) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.

(xiv) Do surprise checking of cash balances.

(xv) See that cash collections are insured and the policy is in force.

Question 11

*What are audit working papers? Discuss various contents of Permanent Audit File and Current File.*

**Answer**

**Audit Working Papers:** Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor. As per SA 230 “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).

Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

In case of recurring audits, auditors generally prepare **two types of audit files.**
(1) Permanent Audit file: It includes-

(i) Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.

(ii) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

(iii) A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.

(iv) Copies of audited financial statements for previous years.

(v) Analysis of significant ratios and trends.

(vi) Copies of management letters issued by the auditor, if any.

(vii) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.

(viii) Notes regarding significant accounting policies.

(ix) Significant audit observations of earlier years.

(2) Current Audit file: The current file normally includes-

(i) Correspondence relating to acceptance of annual reappointment.

(ii) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.

(iii) Evidence of the planning process of the audit and audit programme.

(iv) Analysis of transactions and balances.

(v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.

(vi) Evidence that the work performed by assistants was supervised and reviewed.

(vii) Copies of communications with other auditors, experts and other third parties.

(viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.

(ix) Letters of representation or confirmation received from the client.

(x) Conclusions reached by the auditor concerning significant aspects of the audit.

(xi) Copies of the financial information being reported on and the related audit reports.
Question 12

What precautions should be taken by an auditor while applying test check techniques?

Answer

Precautions While Applying Test Check Techniques: While adopting test check technique, an auditor should take following precautions -

(i) The transactions of the concern should be classified under appropriate heads and may be stratified in case of wide variations between the transactions of the same kind.

(ii) Authorisations, documentations, recording of the transactions should be studied right from the beginning to end.

(iii) Evaluating the system of internal control for its efficiency, soundness and capability to produce reliable accounting and financial data.

(iv) Preparation of test check plan with clear audit objective understood by the audit staff.

(v) Un-biased selection of the transactions with reference to the random number tables or other statistical methods.

(vi) Identification of the areas where test check may not be done.

(vii) Based on degree of reliance and the confidence level required in the audit, the number of transactions to be selected for each test plan should be pre-determined.

(viii) Setting up criteria to judge what constitute material or immaterial errors. Further investigation of only material errors be carried out and all immaterial errors may be avoided.

Question 13

Should branch auditor of a company comply with the request of the principal auditor of the company to give photocopy of the working papers pertaining to the branch audit? Explain.

Answer

Ownership of Working Papers: As per SA 230 “Audit Documentation”, working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the clients or other auditors’ access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.
Question 14

Write a short note on the Surprise checks.

Answer

Surprise Checks: Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client’s office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client’s staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management’s attention, so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

Question 15

The management of Ankita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management. Comment.

Answer

Management Representation: According to SA 580 “Written Representations”, the management representation cannot substitute other audit evidence that the auditor could reasonably expect to be available to the auditor.

The audit evidences available for checking receivables- say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

In the given case, the management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. The management of the company also committed to give representation and further owned responsibility for any errors in these respects.

However, just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his
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part if he relies on the management representation without assessing the corroborative available
evidences. There cannot be any restriction on scope of audit in case of statutory audit.

Question 16

The Vidhwat College, an institution managed by Dayal Trust, has received a grant of ₹1.35 crore from Government nodal agencies for funding a project of research on rural health systems in India. Draft an audit programme for auditing this fund in the accounts of the college.

Answer

Audit Programme for Audit of Grant Fund of a College:

(i) The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.

(ii) The government policy on grant should be checked with the relevant application, brochure, and sanction advices.

(iii) The conditions stipulated in award of grant should be studied.

(iv) The receipt of grant should be vouched with bank statement.

(v) The budgeted heads of expenses for the project and actual utilization of the fund should be checked.

(vi) The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.

(vii) The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.

(viii) The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.

(ix) In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.

(x) The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.

(xi) The physical verification of assets pertaining to the project should be done by the management of the college.

(xii) The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilized for the purposes it intended for.
Question 17

In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statement. Give your comments.

Answer

Test Checking in System Based Audit: System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that:

(i) All the transactions and information have been recorded,
(ii) Fraud and errors, if any, in preparing the accounts will be identified,
(iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
(iv) There is compliance with statutory regulations.

After the auditor has ascertained the client’s accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he asserts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

Question 18

Explain the Relationship between materiality and audit risk.

Answer

Relationship between Materiality and Audit Risk: SA 320 on ‘Materiality in Planning and Performing an Audit’ requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an
inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor’s assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

**Question 19**

*Explain in briefly the utility of Working Papers to an auditor.*

**Answer**

**Utility of Working Papers:** Audit working papers are very useful to the auditor in the following way-

(i) It provides guidance to the audit staff with regard to manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff members who signs each schedule.

(iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.

(iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

**Question 20**

*Comment on the following situations/statements:*

(a) Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence.

(b) M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year.

**Answer**

(a) **Accepting Management Certificate without obtaining other Audit Evidence:** As per SA 580 on “Written Representations” in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management.
Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the inventory of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore, the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

(b) **Ownership of Working Papers:** As per SA 230 on “Audit Documentations” 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.

Working papers are the important records of the auditor. They serve as evidence of the auditor’s exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

**Question 21**

*What does SA 230 says about utility, ownership, custody and retention of working papers?*

**Answer**

**Utility of Working Papers:** According to SA 230 on ‘Audit Documentation’ working papers help in planning and performance of the audit, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor’s opinion.

**Ownership of Working Papers:** Working papers are the property of the auditor and he may, at his discretion, make portions of or extracts from his working papers to his client.

**Custody of Working Papers:** The auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers.

**Retention of Working Papers:** Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. 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.
Question 22
Mention, any four, areas where surprise checks can significantly improve the effectiveness of an audit.

Answer

Areas Where Surprise Checks can Significantly Improve the Effectiveness of an Audit:
Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are-

(i) Verification of cash and investments.
(ii) Inventory.
(iii) Internal control and internal checks.
(iv) Books of prime entries and statutory registers.

Question 23
Write short notes on the following:
(a) Advantages of Statistical sampling in Auditing.
(b) Contents of Audit Note-book.

Answer

(a) Advantages of Statistical Sampling in Auditing: The advantages of using statistical sampling technique in auditing are-

(i) Sample size does not increase in proportion to the increase in the size of population.
(ii) Sample selection is more objective and based on law of probability.
(iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.
(iv) It also provides a means for deriving a calculated risk and corresponding precision.
(v) 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 mistake are not large.

(b) Contents of Audit Note Book: Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following-

(i) Audit queries not cleared immediately.
(ii) Mistakes or irregularities observed during the course of audit.
(iii) Unsatisfactory book-keeping arrangements, costing method.
(iv) Important information about the company which is not apparent from the accounts.
(v) Special points requiring consideration at the time of verification of annual accounts.
(vi) Important matters for future reference.

Question 24

*Write a short note on Knowledge of Client's business.*

**Answer**

**Knowledge of Client's Business:** An auditor can obtain this information from-

(i) Clients annual report to shareholders;
(ii) Minutes of shareholders/board of directors;
(iii) Internal financial management reports of current & previous year;
(iv) Previous year audit working papers;
(v) Discussion with client;
(vi) Clients policy and procedure manual;
(vii) Publications like trade journals, magazines, newspapers; and
(viii) Visit to client's premises.

Question 25

(a) Explain concept of materiality and factors which act as guiding factors to this concept.
(b) Describe set of instructions which an auditor has to give to his client before the start of actual audit.

**Answer**

(a) **Concept of Materiality:** SA 320 “Materiality in Planning and Performing an Audit”, establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.
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.

**Factors to be considered for determining materiality:**

(i) Item of materiality may be determined individually or in aggregate.

(ii) The materiality depends on the regulatory or legal considerations.

(iii) Materiality is not often reckoned with respect to quantitative details above. It has qualitative dimensions as well.

(iv) Even insignificant items in terms of quality may be material in special circumstances.

(v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or ₹ 1,00,000, whichever is higher.

(vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(b) **Following Instructions are given by the Auditor to the Client Before the Start of Audit:**

(i) The accounts should be totalled up and trial balance and final accounts to be kept ready.

(ii) Vouchers should be serially arranged.

(iii) Schedule of trade receivables and trade payables should be prepared.

(iv) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.

(v) A list of bad and doubtful debts should be prepared.

(vi) Schedule of investments should be prepared.

(vii) Certified list of goods returned to be prepared.

(viii) Statement of permanent capital expenditure to be prepared.

(ix) Schedule of deferred revenue expenditures to be prepared.

(x) Names and addresses of managers and other officers should be kept ready.

**Alternative answer**

(i) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies.

(ii) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company.
(iii) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

(iv) Management’s responsibility for making judgements of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.

(v) Management’s responsibility for preparation of the financial statements as a going concern.

Question 26

(a) X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement.

(b) Write a short note “Audit risk at the account balance level and at the class of transactions level”.

Answer

(a) Change in Terms of Engagement: According to SA 210 “Agreeing the Terms of Audit Engagements”, an auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.

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:

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) 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.

In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. The client requested him for a change in the terms of the agreement to avoid qualified/adverse opinion. Hence there is no reasonable justification for change in the terms of engagement.

Thus, the auditor should not agree for change in the terms of engagement letter. He may withdraw from the engagement if possible under law; and determine any obligation to report accordingly.

(b) Audit Risk at the Account Balance Level and at the Class of Transactions Level: Majority of audit procedures are directed to and carried out at the account balance level
and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk-
(i) Financial statement of accounts likely to be susceptible to mismanagement.
(ii) The complexity of underlying transactions which might require the use of the work of an expert.
(iii) The amount of judgment involved in determining account balances.
(iv) Susceptibility of assets to loss or misappropriation.
(v) The completion of unusual and complex transactions, particularly at or near year end.

Question 27
"The auditor is faced with sampling risk in both tests of control and substantive procedures."
Comment on this statement with reference to SA 530 on "Audit Sampling".

Answer
Sampling Risk: As per SA 530 “Audit 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.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

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 substantive procedure i.e. 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 substantive procedure i.e. 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.

Question 28
Write short notes on the following:
(a) Reliability of external confirmations.
(b) Factors governing modes of communication of auditor with those charged with governance.

(c) Procedures to be performed by the auditor in expressing opinion on ‘going concern’ assumption.

Answer

(a) Reliability of External Confirmations: As per SA 505 “External Confirmation”, the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium.

Factors that may indicate doubts about the reliability of a response include that it-

(i) was received by the auditor indirectly; or

(ii) appeared not to come from the originally intended confirming party.

If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

(b) Factors Governing Modes of Communication of Auditor with Those Charged with Governance: As per SA 260, “Communication with Those Charged with Governance”, the form of communication (e.g. whether to communicate orally, or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:-

(i) Whether the matter has been satisfactorily resolved.

(ii) Whether management has previously communicated the matter.

(iii) The size, operating structure, control environment, and legal structure of the entity.

(iv) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity’s general purpose financial statements.

(v) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

(vi) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(vii) The amount of ongoing contact and dialogue the auditor has with those charged with governance.
(viii) Whether there have been significant changes in the membership of a governing body.

(c) **Procedures to be performed by the Auditor in Expressing Opinion on ‘Going Concern’ Assumption:** As per SA 570, “Going Concern”, the following are the relevant procedures that are relevant in this connection:

(i) Analyse and discuss cash flow, profit and other relevant forecasts with management.

(ii) Analyse and discuss the entity’s latest available interim financial statements.

(iii) Read the terms of debentures and loan agreements and determine whether any have been breached.

(iv) Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.

(v) Inquire 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.

(vi) Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.

(vii) Evaluate the entity’s plan to deal with unfilled customer orders.

(viii) Perform audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity’s ability to continue as a going concern.

(ix) Confirm the existence, terms and adequacy of borrowing facilities.

(x) Obtain and review reports of regulatory actions.

(xi) Determine the adequacy of support for any planned disposals of assets.

**Question 29**

*Write short notes on the following:*

(a) **Stratified sampling.**

(b) **Audit Risk and inter-relationship of its components.**

(c) **Quality control for audit work at firm level.**

**Answer**

(a) **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 judgement.

The reason 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.

(b) Audit Risk: An auditor’s judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items.

As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity’s risks; they exist independently of the audit of the financial statements.

The nature of each of these types of risk is discussed below-

(i) **Inherent risk**: It 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. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

(ii) **Control Risk**: It is 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. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity’s objectives relevant to preparation of the entity’s financial statements.

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.

(iii) **Detection Risk**: It is 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. Detection risk relates to the nature, timing, and extent of the auditor’s procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.
Inter-relationship of Components of Audit Risk: Audit risk is a function of the risks of material misstatement and detection risk. The inherent and control risks are functions of the entity’s business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

(c) Quality Control for Audit Work at Firm Level: SA 220 on Quality Control for an Audit of Financial Statements deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. Quality control systems, policies and procedures are the responsibility of the audit firm. Within the context of the firm’s system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm’s system of quality control relating to independence. The requirements are-

(i) Leadership Responsibilities for Quality on Audits: The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

(ii) Relevant Ethical Requirements: Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement.

(iii) 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, and shall determine that conclusions reached in this regard are appropriate.

(iv) Assignment of Engagement Teams: The engagement partner shall be satisfied that the engagement team, and any auditor’s experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and regulatory and legal requirements and enable an auditor’s report that is appropriate in the circumstances to be issued.

(v) Engagement Performance: The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement. He shall take
responsibility for reviews being performed in accordance with the firm’s review policies and procedures and shall take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall determine that an engagement quality control reviewer has been appointed. Further, if differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm’s policies and procedures for dealing with and resolving differences of opinion.

(vi) **Monitoring:** The engagement partner shall consider the results of the firm’s monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

**Question 30**

State briefly Audit Procedures and Audit Techniques.

**Answer**

**Audit Procedures:** Selection of the appropriate audit procedure is again a matter of experience and judgment. For example, the normal procedure for verification of cash balance is counting but this is not practicable in respect of the cash-in-transit. The auditor has to think in advance about the possibilities of departure from the normal procedure and the areas likely to be affected thereby. The procedure should provide for such situations in the programme. Knowledge about accounting may be conveniently used in assembling the procedures in the most rational and natural manner.

According to SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, 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. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit.

Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention. For example, such audit procedures may include inquiring of the entity’s management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances or disclosures.

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

(i) **Posting checking**
(ii) Casting checking
(iii) Physical examination and count
(iv) Confirmation
(v) Inquiry
(vi) Year-end scrutiny
(vii) Re-computation
(viii) Tracing in subsequent period
(ix) Bank Reconciliation.

It may be noted that the two terms, procedure and techniques, are often used interchangeably, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

Question 31

“It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter”. **Explain those situations where new engagement letter is to be sent.**

Answer

**Issue of Audit Engagement Letter in Recurring Audits:** As per SA 210, “Agreeing the Terms of Audit Engagements”, 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.

It is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement. However, in the following situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms-

(i) Any indication that the entity misunderstands the objective and scope of the audit.
(ii) Any revised or special terms of the audit engagement.
(iii) A recent change in senior management or board of directors.
(iv) A significant change in ownership.
(v) A significant change in nature or size of the entity's business.
(vi) A change in legal or regulatory requirements.
(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

**Question 32**

*What is continuous audit? What are the precautions which should be taken to avoid the disadvantages of continuous audit?*

**Answer**

**Continuous Audit:** A continuous audit is one in which the auditor’s staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial period.

The disadvantages of a continuous audit can be avoided if the following precautions are taken:

(i) During the course of each visit, work should be completed up to a definite stage so as to avoid loose ends.

(ii) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.

(iii) The visits should be at irregular intervals of time so that the client’s staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.

(iv) The nominal accounts should be checked only at the time of final closing.

(v) The client’s staff should be instructed not to alter or correct audited figures. The auditor should also devise a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client’s staff.

**Question 33**

*Are surprised checks desirable in audit, if so, give important recommendations.*

**Answer**

**Need of Surprise Checks:** The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients’ transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

The following are the important recommendations-

(i) Surprise checks should be considered as a desirable part of each audit.
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(ii) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

1. Verification of cash and investments.
2. Test-verification of stores and inventories and the records relating thereto.
3. Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

(iii) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(iv) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.

(v) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(vi) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

Question 34

"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." Discuss.

Answer

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 a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or 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 SAs 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-
(i) the original engagement; or
(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

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-

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) 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.

Question 35

With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Answer

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.

Question 36

Write a short note on Random sampling.
Answer

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. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹5,000 to ₹25,000 and not in the range between ₹25 to ₹2,50,000.

(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. For example in the above case, trade receivables balances may be divided into four groups as follows:

   (a) balances in excess of ₹1,00,000;
   (b) balances in the range of ₹75,000 to ₹1,00,000;
   (c) balances in the range of ₹25,000 to ₹75,000; and
   (d) balances below ₹25,000.

Question 37

State with reasons (in short) whether the following statement is correct or incorrect:

Written representation by management as to the quality of inventory is substitute for verification.

Answer

Incorrect: Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership) and in identifying its quality for example, obsolete, damaged or ageing inventory. Written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.
Alternative Reason for incorrect answer may be given as: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Question 38

Write a short note on ‘Matters that the auditor may consider when obtaining an understanding of the nature of the entity’.

Answer

Matters that the Auditor may consider when obtaining an understanding of the nature of the entity: As per SA 315 “Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment”, following are some of the examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity-

(i) Business operations – such as:

- Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
- Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- Alliances, joint ventures, and outsourcing activities.
- Geographic dispersion and industry segmentation.
- Location of production facilities, warehouses, and offices, and location and quantities of inventories.
- Key customers and important suppliers of goods and services, employment arrangements.
- Research and development activities and expenditures.
- Transactions with related parties.

(ii) Investments and investment activities – such as:

- Planned or recently executed acquisitions or divestitures.
- Investments and dispositions of securities and loans.
- Capital investment activities.
Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

(iii) Financing and financing activities – such as:

- Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

(iv) Financial reporting – such as:

- Accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
- Revenue recognition practices.
- Accounting for fair values.
- Foreign currency assets, liabilities and transactions.
- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

Exercise

1. The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles. Explain

2. Distinguish between:
   (a) Concurrent Audit and Annual Audit.
   (b) Audit Principles and Audit Techniques.

3. Write short notes on the following:
   (a) Continuous Audit
   (b) Audit Working Papers

4. Comment on the following:
   (i) Concurrent audit provides a supplementary management tool.
   (ii) Audit Risk and its Assessment.
5 State briefly six important aspects to be considered by an auditor while conducting an audit.
6 What are Audit Working Paper and why should they be carefully preserved by the auditor?
7 (a) What precautions are to be taken in the application of test-checking techniques?
(b) Mention any of the four items which are not suitable for test-checking.