

PREPARATION FOR AN AUDIT

BASIC CONCEPTS

Audit process

- (a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.
- (b) Examination and evaluation of the nature, extent and efficacy of the system of internal control..
- (c) Ascertaining the arithmetical accuracy of the books of accounts.
- (d) Examining the documentary evidence and the authority in support of the transaction:
- (e) Checking the validity of transactions with reference to :
 - (i) provisions affecting the accounts and audit in any Act or Rules;
 - (ii) rules and regulations governing the constitution and management of the organisation
 - (iii) minute books for appropriate sanction;
 - (iv) other legal documents and
 - (v) well recognised accounting principles and practices
- (f) Ensuring that there is adequate disclosure of information.
- (g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.
- (h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.
- (i) 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.
- (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.

Audit techniques

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny
7. Re-computation
8. Tracing in subsequent period
9. Bank Reconciliation

Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. Infact without adequate knowledge of client's business, a proper audit is not possible. SA-315 on "Knowledge of the Business" deals in detail about the significance of such knowledge on the part of the auditor.

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, the auditor can obtain such knowledge from :

- The client's annual reports to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers, and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.

Auditing and Assurance

- 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.

Development of an Overall Plan:

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit :

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention.
- The degree of reliance he expects to be able to place 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, if any, in the audit.
- 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 starting point within the first 50, each 50th sampling unit thereafter is selected.
- (c) Monetary Unit sampling 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 which the auditor selects the sample without following a structured technique.
- (e) Block selection 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.

Auditing and Assurance

Question 1

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

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 need to be followed

Question 2

What are the meaning and purposes of Sampling? Explain in the light of the 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 (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 Rs.1,00,000
- (ii) Vouchers between Rs.25,000 and Rs.1,00,000
- (iii) Vouchers below Rs.25,000

The auditor can then decide to check all vouchers above Rs.1,00,000, 50% between 25,000 and Rs.1,00,000 and 25% of those below Rs.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 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 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 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 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.
- (e) Block selection 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

Auditing and Assurance

appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Question 3

Write a short note 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.

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 of 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

What do you understand by the term "Government Audit"?

Answer

Government Audit

Government audit is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them.

It also involves presentation of a report containing explanatory comments on audit findings, together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Government audit serves as a mechanism or process for public accounting of Government funds. It also provides public accounting of the operational management, programmes and policy aspects of public administration as well as accountability of the officials administering them.

In India, the function of Government Audit is discharged by the independent statutory authority of the C&AG of India. The audit of government expenditure is one of the major

Auditing and Assurance

components of the Government audit. Apart from this, audit of receipts, stores and stock and performance audit is also included.

The nature of government audit is different vis-a-vis financial audit since it involves aspects of accountability and propriety.

Initially, government auditing in India as elsewhere was primarily expenditure-oriented.

Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, i.e., commercial audit came into being.

There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executive of the spending agencies to the sanctioning or controlling authorities.

The purposes or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C & AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Question 5

“The audit firm should implement quality control policies and procedures”, Explain.

Answer

SA 220 “Quality Control for Audit Work” requires that the audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with SA. Compliance with all SAs would necessitate that the quality control policies to be adopted by a firm would incorporate that standards of professional requirements, technical competence, training, proficiency, etc. are observed at the firm level.

SA 220 suggests two fold approach to quality control, first, at the firm level and secondly, at the individual audit level. At the firm level, the objectives of quality control policies to be adopted by an audit firm normally incorporates elements such as professional requirements, skills and competence, assignment, delegation, consultation, acceptance and retention of clients and monitoring of work performed by the junior levels.

It is also quite necessary that the firm’s general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.

At the individual audit level, the auditor should carefully direct, supervise and review work delegated to assistants. The direction of work involves informing assistants of their responsibilities and the objectives of the procedures they have to perform.

The audit programme is an important tool for the communication of audit directions. Regarding supervision, personnel carrying out supervisory responsibilities perform the following functions during the audit:

- (a) monitor the progress of the audit to consider whether;
 - (i) assistants have the necessary skills and competence to carry out their assigned tasks;
 - (ii) assistants understand the audit directions; and
 - (iii) the work is being carried out in accordance with the overall audit plan and the audit programme.
- (b) become informed of and address significant accounting and auditing questions raised during by the audit, assessing their significance and modifying the overall audit plan and the audit programme as appropriate; and
- (c) resolve any difference of professional judgement between personnel and consider the level of consultation that is appropriate.

Finally, the work performed by each assistant would required to be reviewed by a personnel of at least general competence to ascertain that the work has been carried out properly.

Question 6

Define 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

Auditing and Assurance

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 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.

Note: SA 210 "Agreeing the Terms of Audit Engagement", 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 7

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.

- (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.

(NOTE: SA 315 had been issued in December, 2007. The date this Standard (along with SA 330) becomes effective, the existing Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn).

Question 8

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

Auditing and Assurance

- (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 9

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



Auditing and Assurance

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:

- (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.

Question 10

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 11

State briefly Audit Procedures and Audit Techniques.

Answer

As per SA 200, on Basic Principles Governing an Audit states, “the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. Therefore, audit procedures are broadly classified in two categories, viz., compliance procedures and substantive procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. In obtaining audit evidence from compliance procedures, the auditor is concerned with assertions that the control exists, the control is operating effectively and the control has so operated throughout the period of intended reliance. So the auditor is concerned with the existence, effectiveness and continuity of the control system.

Substantive procedures are tests designed to obtain evidence as to the completeness, accuracy and validity of the data produced by accounting system. They are of two types:

- (1) tests of details of transactions and balances.
- (2) analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

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:

- Posting checking
- Casting checking
- Physical examination and count
- Confirmation
- Inquiry
- Year-end scrutiny
- Re-computation
- Tracing in subsequent period Bank Reconciliation

Auditing and Assurance

The two terms, procedure and techniques, are often used interchangeably; in fact, 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 12

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 13

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:

- (1) The audit programme lists down areas of audit before commencement.
- (2) The audit timing is built therein; thereby it becomes a schedule of audit plan.
- (3) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.
- (4) It specifies the procedures to be checked during the audit.
- (5) 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.
- (6) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.
- (7) 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.
- (8) 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.

- (1) The partnership deed should be first scrutinized.
- (2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
- (3) The internal control for collections from sale of tickets should be checked.
- (4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.
- (5) Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.
- (6) Check that the cash balance and ticket sales from stock is daily checked by the manager.

Auditing and Assurance

- (7) Check that the collections are banked daily, the very next day.
- (8) See rates for each class and the ticket rates are as per current prices.
- (9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
- (10) Check the relation between the amounts of tax collected and sales.
- (11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
- (12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
- (13) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.
- (14) Do surprise checking of cash balances.
- (15) See that cash collections are insured and the policy is in force.

Question 14

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.

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 15

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

Answer

While adopting test check technique, an auditor should take following precautions:-

Auditing and Assurance

- (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 16

Answer the following:

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

As per SA 230 on 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 17

Write short notes on the following:

- (a) *Advantages of Statistical sampling in Auditing.*
- (b) *Surprise checks.*

Answer

(a) 'Advantage of statistical sampling in auditing'

- (i) The sample size does not increase in proportion to the increase in the size of population.
- (ii) The selection of more objective and is based on mathematical law of probability.
- (iii) This method gives a minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for taking a calculated risk and corresponding precision i.e., the probable difference in the result due to checking of transaction on sample basis in lieu of checking the entire universe.
- (v) It may provide a better description of large mass of data than a complete examination of all the data.

(b) 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 stock, 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 18

Auditing and Assurance

Answer the following:

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.

Answer

Management Representation: The management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit.

The management representation, according to SA 580 - Written Representations, 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.

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 part if he relies on the management representation without assessing the corroborative available evidences.

Question 19

The Vidhwat College, an institution managed by Dayal Trust, has received a grant of Rs 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 of grant fund of a college:

1. The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
2. The government policy on grant should be checked with the relevant application, brochure, and sanction advices.

3. The conditions stipulated in award of grant should be studied.
4. The receipt of grant should be vouched with bank statement.
5. The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
6. 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.
7. 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.
8. 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.
9. 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.
10. The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.
11. The physical verification of assets pertaining to the project should be done by the management of the college.
12. 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 20

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

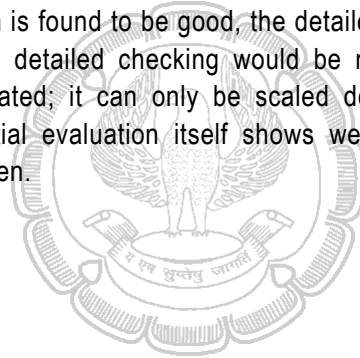
Test Checking in System Based Audit: System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control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

Auditing and Assurance

- (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 resorts 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.



EXERCISES

Question 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

Question 2

Distinguish between:

- (a) Concurrent Audit and Annual Audit.
- (b) Audit Principles and Audit Techniques.

Question 3

Write short notes on the following:

- (a) Continuous Audit
- (b) Audit Working Papers

Question 4

Comment on the following:

- (i) Concurrent audit provides a supplementary management tool.
- (ii) Audit Risk and its Assessment.

Question 5

State briefly six important aspects to be considered by an auditor while conducting an audit.

Question 6

What are Audit Working Paper and why should they be carefully preserved by the auditor?

Question 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.